AU-C Section 708

Consistency of Financial Statements

Source: SAS No. 122; SAS No. 136.

Effective for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise indicated.

Introduction

Scope of This Section

.01 This section addresses the auditor's evaluation of the consistency of the financial statements between periods, including changes to previously issued financial statements and the effect of that evaluation on the auditor's report on the financial statements.

Effective Date

.02 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

Objectives

.03 The objectives of the auditor are to

a. evaluate the consistency of the financial statements for the periods presented and

b. communicate appropriately in the auditor's report when the comparability of financial statements between periods has been materially affected by a change in accounting principle or by adjustments to correct a material misstatement in previously issued financial statements.

Definition

.04 For purposes of generally accepted auditing standards, the following term has the meaning attributed as follows:

Current period. The most recent period upon which the auditor is reporting.

Requirements

Evaluating Consistency

.05 The auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by a change in accounting principle or by adjustments to correct a material misstatement in previously issued financial statements. (Ref: par. .A1)

.06 The periods included in the auditor's evaluation of consistency depend on the periods covered by the auditor's opinion on the financial statements. When the auditor's opinion covers only the current period, the auditor should evaluate whether the current-period financial statements are consistent with those of the preceding period, regardless of whether financial statements for the preceding period are presented. When the auditor's opinion covers two or more periods, the auditor should evaluate consistency between such periods and the consistency of the earliest period covered by the auditor's opinion with the period prior thereto, if such prior period is presented with the financial statements being reported upon. The auditor also should evaluate whether the financial statements for the periods being reported upon are consistent with previously issued financial statements for the relevant periods. (Ref: par. .A2–.A3)

Change in Accounting Principle

.07 The auditor should evaluate a change in accounting principle to determine whether (Ref: par. .A4–.A6)

a. the newly adopted accounting principle is in accordance with the applicable financial reporting framework,

b. the method of accounting for the effect of the change is in accordance with the applicable financial reporting framework,

c. the disclosures related to the accounting change are appropriate and adequate, and

d. the entity has justified that the alternative accounting principle is preferable.

.08 If the auditor concludes that the criteria in paragraph .07 have been met, and the change in accounting principle has a material effect on the financial statements, the auditor should include an emphasis-of-matter paragraph[1] in the auditor's report that describes the change in accounting principle and provides a reference to the entity's disclosure. If the criteria in paragraph .07 are not met, the auditor should evaluate whether the accounting change results in a material misstatement and whether the auditor should modify the opinion accordingly.[2] (Ref: par. .A7–.A9)

.09 The auditor should include an emphasis-of-matter paragraph relating to a change in accounting principle in reports on financial statements in the period of the change, and in subsequent periods, until the new accounting principle is applied in all periods presented. If the change in accounting principle is accounted for by retrospective application to the financial statements of all prior periods presented, the emphasis-of-matter paragraph is needed only in the period of such change.

.10 The auditor should evaluate and report on a change in accounting estimate that is inseparable from the effect of a related change in accounting principle like other changes in accounting principle, as required by paragraphs .08–.09. (Ref: par. .A10)

.11 When a change in the reporting entity results in financial statements that, in effect, are those of a different reporting entity, the auditor should include an emphasis-of-matter paragraph in the auditor's report that describes the change in the reporting entity and provides a reference to the entity's disclosure, unless the change in reporting entity results from a transaction or event. The requirements in paragraph .09 also apply. (Ref: par. .A11)

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[1] Paragraphs .06–.07 of section 706A, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report.*

[2] See section 705, *Modifications to the Opinion in the Independent Auditor's Report.*

.12 If an entity's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing entity's financial statements, the auditor should include an emphasis-of-matter paragraph in the auditor's report to describe the change in accounting principle. The requirements in paragraph .09 also apply.

Correction of a Material Misstatement in Previously Issued Financial Statements

.13 The auditor should include an emphasis-of-matter paragraph in the auditor's report when there are adjustments to correct a material misstatement in previously issued financial statements. The auditor should include this type of emphasis-of-matter paragraph in the auditor's report when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent periods. (Ref: par. .A12–.A13)

.14 The emphasis-of-matter paragraph should include

a. a statement that the previously issued financial statements have been restated for the correction of a material misstatement in the respective period and

b. a reference to the entity's disclosure of the correction of the material misstatement. (Ref: par. .A14)

.15 If the financial statement disclosures relating to the restatement to correct a material misstatement in previously issued financial statements are not adequate, the auditor should address the inadequacy of disclosure as described in section 705, *Modifications to the Opinion in the Independent Auditor's Report.*

Change in Classification

.16 The auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change is also either a change in accounting principle or an adjustment to correct a material misstatement in previously issued financial statements. If so, the requirements of paragraphs .07–.15 apply. (Ref: par. .A15–.A16)

Application and Other Explanatory Material

Evaluating Consistency (Ref: par. .05–.06)

.A1 Unless the auditor's report explicitly states otherwise, the auditor's report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by a change in accounting principle or by adjustments to correct a material misstatement in previously issued financial statements. There may be no effect on comparability between or among periods because either (*a*) no change in an accounting principle has occurred, or (*b*) there has been a change in an accounting principle or in the method of application, but the effect of the change on the comparability of the financial statements is not material. When no material effect on comparability results from a change in accounting principle or an adjustment to previously issued financial statements, the auditor need not refer to consistency in the auditor's report.

.A2 The periods covered in the auditor's evaluation of consistency depend on the periods covered by the auditor's opinion on the financial statements. If an entity presents comparative financial statements and has a change in auditors in the current year, the auditor evaluates consistency between the year covered by the auditor's opinion and the immediately preceding year in accordance with the requirements in paragraph .06.

.A3 When an entity accounts for a change in accounting principle by applying the principle to one or more prior periods that were included in previously issued financial statements, as if that principle had always been used (commonly referred to as *retrospective application*), the financial statements presented generally will be consistent. However, the previous periods' financial statements presented with the current period's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous periods' financial statements on which the auditor previously reported. The evaluation required by paragraph .06 encompasses previously issued financial statements for the relevant periods.

Change in Accounting Principle (Ref: par. .07)

.A4 A change in accounting principle is a change from one accounting principle in accordance with the applicable financial reporting framework to another accounting principle in accordance with the applicable financial reporting framework when (1) two or more accounting principles apply or (2) the accounting principle formerly used is no longer in accordance with the applicable financial reporting framework. A change in the method of applying an accounting principle also is considered a change in accounting principle.

.A5 The applicable financial reporting framework usually sets forth the method of accounting for the effects of a change in accounting principle and the related disclosures.

.A6 The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the applicable financial reporting framework.

Reporting on Changes in Accounting Principles (Ref: par. .08–.11)

.A7 The following is an example of an emphasis-of-matter paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

> *Emphasis of Matter*
>
> As discussed in Note X to the financial statements, in [*insert year(s) of financial statements that reflect the accounting method change*], the entity adopted new accounting guidance [*insert description of new accounting guidance*]. Our opinion is not modified with respect to this matter.

.A8 The following is an example of an emphasis-of-matter paragraph when the entity has made a voluntary change in accounting principle (that is, other than a change due to the adoption of a new accounting pronouncement).

> *Emphasis of Matter*
>
> As discussed in Note X to the financial statements, the entity has elected to change its method of accounting for [*describe accounting method change*] in

[*insert year(s) of financial statements that reflect the accounting method change*]. Our opinion is not modified with respect to this matter.

.A9 If a change in accounting principle does not have a material effect on the financial statements in the current year but the change is expected to have a material effect in later years, the auditor is not required to recognize the change in the auditor's report in the current year. The applicable financial reporting framework may include a requirement for the entity to disclose such situations in the notes to the financial statements. Section 700, *Forming an Opinion and Reporting on Financial Statements*, section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, as applicable, and section 705 require the auditor to evaluate the appropriateness and adequacy of disclosures in connection with forming an opinion and reporting on the financial statements.[3] [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 136.]

.A10 Paragraph .10 requires the auditor to evaluate and report on a change in accounting estimate that is inseparable from the effect of a related change in accounting principle like other changes in accounting principle. It is sometimes difficult to differentiate between a change in an accounting estimate and a change in an accounting principle because the change in accounting estimate may be inseparable from the effect of a related change in accounting principle. For example, when a change is made to the method of depreciation of an asset to reflect a change in the estimated future benefit of the asset or the pattern of consumption for those benefits, such change in accounting may be inseparable from a change in estimate.

Change in Reporting Entity

.A11 A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit, does not require recognition in the auditor's report. Examples of a change in the reporting entity that is not a result of a transaction or event include

a. presenting consolidated or combined financial statements in place of financial statements of individual entities.

b. changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented.

c. changing the entities included in combined financial statements.

Correction of a Material Misstatement in Previously Issued Financial Statements (Ref: par. .13–.14)

.A12 A change from an accounting principle that is not in accordance with the applicable financial reporting framework to one that is in accordance with the applicable financial reporting framework is a correction of a misstatement.

.A13 Section 560, *Subsequent Events and Subsequently Discovered Facts*, addresses the auditor's responsibilities when adjustments have been made to correct a material misstatement in previously issued financial statements.

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[3] Paragraph .15 of section 700, *Forming an Opinion and Reporting on Financial Statements*, paragraph .40 of section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, and paragraphs .07 and .A7 of section 705. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 136.]

Reporting on a Correction of a Material Misstatement in Previously Issued Financial Statements

.A14 The following is an example of an emphasis-of-matter paragraph when there has been a correction of a material misstatement in previously issued financial statements:

> *Emphasis of Matter*
>
> As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement. Our opinion is not modified with respect to this matter.

Change in Classification (Ref: par. .16)

.A15 Changes in classification in previously issued financial statements do not require recognition in the auditor's report unless the change represents the correction of a material misstatement or a change in accounting principle. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were classified incorrectly in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement.

.A16 In some cases, changes in classification in previously issued financial statements may result from changes in the entity's business or operating structure. The auditor may need to obtain a further understanding of the underlying rationale for such reclassifications to determine whether the requirements of paragraph .16 apply.