

An Examination of Audit Reporting for Accounting Principles Changes

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Abstract

This article examines audit reporting of accounting principles changes under SAS 58 and compares the results to prior research. The study indicates that auditors both before and after SAS 58 exhibited great diversity in their decisions to modify reports for changes in principles. This lack of uniformity suggests report modifications for changes in principle may be providing little or no relevant information to users.

Introduction

Companies occasionally change generally accepted accounting principles between years (e.g., changing from an accelerated depreciation method to the straight-line method). When this occurs, a company's financial statements are inconsistent because different accounting methods were used. Typically, the cumulative effect of making the change in principle is reported as a component of income in the year of the change. The nature of the change, justification for the change, and its pro forma effect on net income are also disclosed in the footnotes to the financial statements.

Inconsistency in applying accounting principles requires special consideration by the company's independent auditors when preparing the audit report. Under the current standard, Statement on Auditing Standards (SAS) 58 (AICPA, 1988), an auditor must modify the standard audit report by adding an explanatory paragraph which identifies the type of change in principle and the year in which it occurred. The explanatory paragraph is not a qualification of the auditor's opinion

but rather additional information provided in the audit report. Report modification is required only if the auditor deems the effect of the change material in relation to the company's financial statements. SAS 58 specifically states that audit reports should not be modified for accounting principles changes having immaterial effects. SAS 58 became effective for audit reports issued on or after January 1, 1989.

Prior to SAS 58, SAS 2 (AICPA, 1972) established auditors' guidelines for reporting on inconsistency and prescribed report modification, which was an opinion qualification, if the effect of the change in principle was deemed material. SAS 2 did not preclude report modification if the effect was considered immaterial. Thus, two important differences exist between SAS 2 and SAS 58. First, SAS 2 required a qualified opinion for a material change in principle. SAS 58 does not require opinion qualification but simply an additional explanatory paragraph highlighting the change in principle. Second, SAS 2 did not preclude report

modification for immaterial changes while SAS 58 does.

These differences between SAS 2 and SAS 58 present a unique opportunity to examine auditors' decision making under two distinct reporting requirements. Previous research concentrated on auditor reporting on inconsistency before SAS 58. This study compares current auditor reporting under SAS 58 with the results of prior research and evaluates the usefulness of report modifications for accounting principles changes.

Literature Review on Pre-SAS 58 Studies

Pre-SAS 58 research on consistency reporting examined the dollar effects of accounting principles changes and attempted to make inferences about auditors' materiality decisions used in modifying their reports. Neumann (1968) analyzed financial statement data for firms that either changed depreciation methods or changed methods of accounting for investment tax credits. His primary conclusion was that auditors do not follow uniform patterns in making decisions concerning report modification for accounting principles changes. He felt too much diversity existed in practice and questioned the usefulness of the consistency standard for users.

Neumann (1969) studied the income effects of all types of accounting principles changes for 300 Fortune 500 companies. Again, he found a lack of consensus in the quantitative materiality effects of the changes and the auditors' decisions to modify their reports. He noted that Woolsey's (1954) research indicated that auditors in general considered items material if they exceeded 14 percent of income. Yet, Neumann found that one-quarter of the audit reports modified in his sample were for income effects less than 3 percent; one-half of the modified reports were for income effects less than 6 percent. These report modifications for seemingly immaterial effects were not concentrated in any one year, type of accounting principle change, industry, or accounting firm. Neumann concluded that auditors may be overly zealous in

modifying their reports for accounting principles changes.

Frishkoff (1970) attempted to develop a multiple discriminant (MDA) model to predict an auditor's decision to modify/not modify a report for inconsistency. He examined 17 independent variables; only one, the effect of the change on net income, was statistically significant (.025 level). However, the model containing this one variable had little or no predictive value in classifying new observations. This model's inability to predict provided more evidence on the lack of uniformity used by auditors in making decisions to modify their reports for accounting principles changes.

Morris, Nichols, and Pattilo (1984) present additional evidence on the lack of consensus among auditors in reporting on inconsistency. They examined audit report consistency modifications for companies adopting the accounting standard requiring capitalization of interest. Audit firms modified opinions for income effects as low as 1 percent and issued nonmodified opinions for income effects as high as 38 percent. Using this same data set, Morris and Nichols (1988) studied the relationship between auditing firm structure and report modification for accounting principles changes. They found that more structured auditing firms demonstrated greater uniformity in their modification/nonmodification decisions than did their less structured counterparts.

Chewning, Pany, and Wheeler (1989 and 1993) analyzed data from the 1980s and therefore provide the most recent pre-SAS 58 report modification studies. In performing their analyses, they relied upon a comprehensive study by Holstrum and Messier (1982), which synthesized much of the previous empirical research concerning materiality.

Holstrum and Messier concluded that the effect of an item on income from continuing operations is an important factor in determining whether it is material. However, there was significant diversity concerning materiality thresholds.

Holstrum and Messier indicated that, for public companies, items with a greater than 10 percent effect on income from continuing operations would usually be considered material by all parties. Items less than 4 to 5 percent would typically be considered immaterial by all groups, and items between 4 percent and 10 percent are in a gray area for which no consensus exists.

As expected, Chewning, Pany, and Wheeler (1989 and 1993) found that the large majority (97.5 percent) of accounting principles changes with effects greater than 10 percent resulted in modified reports. Surprisingly, however, they found that 89.5 percent of the income effects between 4 percent and 10 percent resulted in report modification and 60.6 percent of the income effects less than 4 percent also ended up with modified reports. Just as Neumann (1968 and 1969) concluded based on data from the 1950s, Chewning, Pany, and Wheeler reaffirmed that after 30 years auditors still appeared to be overly zealous in modifying reports for accounting principles changes. Income effects that were apparently immaterial resulted in modified reports.

In an attempt to explain the modification decisions in the less-than-4 percent effect group, Chewning, Pany, and Wheeler (1993) examined other factors. They tested to determine whether the report modification was related to auditing firm structure (Morris and Nichols, 1988), auditor litigation experience (Palmrose, 1988), and client financial condition (Zmijewski, 1984). None of these factors were significantly related to the modification decisions for the less-than-4 percent effect group.

Why did so many auditors modify their reports for accounting principles changes with seemingly immaterial effects? The answer might be found in the nature of the previous auditing standard (SAS 2), which required modification for material changes and allowed modification for immaterial changes. Auditors were not necessarily required to make materiality judgments in this area. An auditor could choose to modify a report

for any change in principle, regardless of its materiality. Thus, the wording of the standard may have contributed to much of the lack of uniformity in practice.

SAS 58 more sharply defines the auditor's reporting responsibilities for accounting principles changes. Only material changes require report modification; immaterial changes should not be highlighted in the auditors report. One might assume the number of report modifications under SAS 58 would be lower than under SAS 2 as auditors are now precluded from modifying reports for immaterial changes. Because of the more clearly defined reporting requirements in SAS 58, increased uniformity in reporting accounting principles changes should result.

Methodology

To obtain a data base of firms reporting the income effect of accounting principles changes, the primary financial statements of every company in Moody's Industrial Manual were examined for 1988-1993. This time period was chosen because auditors reporting on these financial statements were required to comply with SAS 58. During this six-year period, 1,296 companies disclosed cumulative effects of changing accounting principles in their income statements. The types of principle changes varied widely, but the overwhelming majority were mandatory changes (i.e., changes necessitated by the issuance of new accounting standards).

Through either Compact Disclosure or Q-Data, the audit reports for each of the 1,296 companies were reviewed. Based upon the wording of SAS 58, an audit report containing an additional paragraph referencing the accounting principle change indicates a conscious decision by the auditor that the effect of the change is material. A report containing no such reference to the change suggests the auditor deemed the change's effect immaterial. Relying on prior research stating that the primary quantitative factor in a materiality decision is the item's effect on income, the cumulative

effect of each change was computed as a percentage of income from continuing operations after taxes. The data in the two distinct groups (i.e., modified versus nonmodified groups) were analyzed to determine any patterns that might exist in auditors' materiality judgments.

Results

Of the 1,296 companies reporting effects of accounting principles changes in their income statements, only 119 received nonmodified reports by their auditors. The remaining 1,177 companies were given modified reports referencing the accounting change. Table 1 shows the two groups divided in the immaterial/gray area/material categories provided in prior research (Holstrum and Messier, 1982). The data demonstrate that auditors still appear highly inclined to modify reports for accounting principles changes. Notice in the less-than-4 percent category, in which Holstrum and Messier concluded that all groups would consider immaterial, the audit reports were modified in 82.8 percent of the cases. An almost equal percentage (81.8 percent) in the gray area were modified. Based on the wording in SAS 58 that only material accounting principles changes should result in modified reports, the number of modified reports in these two income categories seems unduly large.

Surprising findings also occurred in the greater-than-10 percent category. Although the vast majority (94.1 percent) of income effects in this category resulted in modified reports, this group contained the largest number of nonmodified reports. Fifty-six (47.1 percent) of the companies with nonmodified reports had income effects greater than 10 percent.

To compare the post-SAS 58 (Table 1) and pre-SAS 58 results, Table 2 shows the immaterial/gray area/material categories from the Chewning, Pany, and Wheeler (1993) study. Chi-square tests (.01 level) revealed that only the less-than-4 percent category differed between the two data sets, and the direction of the difference was

the opposite expected. Intuitively, post-SAS 58 auditors should have modified a lower percentage of reports in this less-than-4 percent category than did their pre-SAS 58 counterparts, but this did not occur. What could have caused so many post-SAS 58 auditors to modify their reports for seemingly immaterial effects despite the auditing standard's clear wording that reports should not be modified for immaterial effects?

One plausible explanation might be the nature of the modification under SAS 58. Pre-SAS 58 report modifications involved a qualified ("except for") opinion noting that accounting principles had not be consistently applied. Under SAS 58, there is no opinion qualification and consistency is not mentioned. A modified report simply notes in an additional paragraph the type of change and the year it occurred. Readers are referred to a footnote in the financial statements for further information on the change. Unlike pre-SAS 58 audit reports where consistency modification meant a qualified auditor's opinion, modified post-SAS 58 reports carry no such negative connotations. Post-SAS 58 auditors may be modifying such a high percentage of reports for accounting principles changes because their clients do not protest report modification. By modifying their reports, auditors are making safe decisions with little or no negative repercussions.

Another factor that might affect an auditor's propensity to modify a report is the size of the client. The liability risk of being sued for issuing a nonmodified report when a modified report is warranted increases as the size of the client increases. This increased liability risk results from the larger number of stockholders relying on the audit report. Table 3 shows the modified/nonmodified groupings separated into client asset size categories. The size groupings are based on arbitrary cutoffs, but they clearly demonstrate an increasing likelihood that auditors will modify reports as client size increases. Chi-square tests revealed the modified/nonmodified numbers differed (.01 level) between the asset categories.

Table 1
Modified and Nonmodified Reports by Income Categories
(Post-SAS 58)

Effect on Income	Number modified	Number nonmodified	Total	Percent modified
< 4 percent of income	125	26	151	82.8%
4 - 10 percent of income	166	37	203	81.8
> 10 percent of income	886	56	942	94.1
Total	1177	119	1296	

Table 2
Modified and Nonmodified Reports by Income Categories
(Pre-SAS 58)

Effect on Income	Number modified	Number nonmodified	Total	Percent modified
< 4 percent of income	77	50	127	60.6%
4 - 10 percent of income	68	8	76	89.5
> 10 percent of income	79	2	81	97.5
Total	224	60	284	

Table 3
Modified and Nonmodified Reports by Client Asset Size

Client Asset Siize	Number modified	Number nonmodified	Total	Percent modified
> \$5 billion	173	4	177	97.7%
\$500 mil. to \$5 bil.	493	39	532	92.7
< \$500 million	511	76	587	87.1
Total	1177	119	1296	

Client size appeared to be a factor only for the entire sample. When size was examined in relation to the income effect groupings (< 4 percent, 4-10 percent, and > 10 percent), the modified/nonmodified groups did not differ by asset size. This is not surprising, however, if the income effect is the primary criterion used in making materiality decisions. More specifically, when the income effect is isolated as in Table 1, the client size effect becomes less important.

A final area examined was the propensity of individual auditing firms to modify reports. Morris and Nichols (1988) showed that pre-SAS 58 report modification decisions were affected by firm type. Table 4 shows the number of modified/nonmodified reports segregated by auditing firm. Chi-square tests revealed that the firms' modification decisions differed significantly (.01 level).

Kinney (1986) provided an ordinal ranking of the then Big Eight CPA firms by firm structure with 15 being the most structured and 5 being the least structured. Unfortunately, Kinney's work has not been replicated since the merger of certain Big Eight firms; thus, no ranking exists for the merged firms. For the four nonmerged firms, however, Kinney's ranking still applies. These four firms

along with their structure rankings and propensities to modify audit reports as found in this study are listed below:

Similar to client size, when the sample was separated by income effect into the three categories (< 4 percent, 4-10 percent, and > 10 percent), auditing firm differences were insignificant. This again suggests that the income effect is the overriding decision criterion.

Table 4
Modified and Nonmodified Reports by Auditing Firm

Auditing firm	Number modified	Number nonmodified	Total	Percent modified
Deloitte & Touche	204	12	216	94.4%
Coopers & Lybrand	169	10	179	94.4
Price Waterhouse	197	14	211	93.4
Ernst & Young	217	26	243	89.3
Arthur Andersen	195	24	219	89.0
KPMG Peat Marwick	153	22	175	87.4
Non Big Six	42	11	53	79.2
Total	1,177	119	1,296	

Implications and Conclusions

Prior research demonstrates that pre-SAS 58 auditors were perhaps too enthusiastic in modifying reports for seemingly immaterial accounting principles changes and showed a lack of uniformity in making these modification decisions. These problems seem to continue

Firm	Structure ranking	Percent of ports modified
KPMG Peat Marwick	5	87.4%
Arthur Andersen	11	89.0
Price Waterhouse	5	93.4
Coopers & Lybrand	5	94.4

Notice that structure appears to be inversely related to the propensity to modify a report for an accounting principle change. This is a logical relationship. For example, KPMG Peat Marwick is more structured than the other three firms indicating that it may have more sharply defined criteria on what constitutes a material effect. Those items falling below its materiality threshold would not result in report modification. Coopers & Lybrand and Price Waterhouse received the lowest structure ranking suggesting that their materiality decision criteria may be less well defined. With less clearly defined criteria for making materiality judgments, auditors for these firms may be more apt to issue modified reports (i.e., the materiality judgment may actually be avoided).

under SAS 58. For whatever reason, auditors now appear even more eager to modify reports for low-level income effects. Report modification decisions vary depending upon individual auditing firms as well as client size. Such a lack of consensus in report modification decisions by auditors suggests these report modifications provide little or no value to users. Even worse, the modification diversity may actually confuse users.

Mittelstaedt's et. al. (1992) capital market study supports the notion that report modifications for accounting principles changes under SAS 58 provide little value to investors. In examining stock price changes for firms receiving modified reports and those receiving nonmodified reports, they found report modification had no impact on share prices.

A reference to accounting principles changes was first required in the audit report in 1934, and it has been a source of debate ever since. The reference was originally included in the report because there was no accounting standard requir-

ing consistent application of GAAP. Thus, the audit report informed users whether accounting principles had been consistently applied. In 1971, Accounting Principles Board Opinion (APBO) 20 (AICPA, 1971), "Accounting Changes," required consistent use of accounting principles or financial statement disclosure if a change in principle occurred. With the advent of APBO 20, the reference to consistent application of GAAP in the audit report seemed redundant.


The Commission on Auditors' Responsibilities (AICPA, 1978) recommended eliminating all references to consistency in the standard audit report. This fueled an Auditing Standards Board (ASB) Exposure Draft (ED) in 1980 proposing a new audit report which would among other things eliminate the reference to consistency. The ED encountered strong opposition, and all proposals were dropped. In 1987, the ASB again issued an ED (AICPA, 1987) which advocated abolishing the consistency reference. The final result (i.e., SAS 58) was a compromise. The reference to consistency was removed from the opinion paragraph, and a change in principle no longer resulted in a qualified opinion. However, SAS 58 still requires auditors to highlight in the audit report any material accounting principles changes.

Strong evidence suggests that reference in the audit report to a change in principle should be removed entirely, unless the change is one with which the auditor does not concur. To be in conformity with GAAP, the financial statements must contain adequate reference to the change. Thus, there is little need for the audit report also to disclose the change. As this study shows, audit report modification decisions for accounting principles changes are not made uniformly. This lack of consensus can only serve to confuse users. Little or nothing would be lost by eliminating the audit report reference to changes in principle while uniformity would be gained.

Suggestions for Future Research

This study examined report modifications

and materiality decisions based on a change in principle's effect on income. An income variable was chosen as the materiality base because prior research indicated the income effect is the primary quantitative factor used by auditors in making materiality judgments. Because of the volatility of income, however, it is possible that more stable materiality bases may be used by auditors. For example, total assets or total revenue would fluctuate less from year to year than income. Perhaps auditors' materiality decisions might appear more uniform if evaluated on these less volatile bases. Future research could test this theory.

Also, this study analyzed post-SAS 58 audit reports for companies that had disclosed the dollar amount of the effect of the change in principle on the income statement. This was done so the effect could be stated in terms of a percentage of income. There are cases in which companies disclose accounting principles changes in their footnotes but do not provide dollar amounts because of their immaterial effects. The audit reports of these companies could be examined to determine auditors' propensities to modify reports for these changes already judged immaterial by company management. Chewning, Pany, and Wheeler (1993) did this in their study of pre-SAS 58 audit opinions. They found that, even for these already declared immaterial changes, 26 percent of the auditors still modified their reports. Future research could reveal how likely post-SAS 58 auditors are to modify their reports for these clearly immaterial amounts. 

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