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American Institute of Certified Public Accountants

GUIDE FOR A REVIEW OF A FINANCIAL FORECAST

PREPARED BY THE FINANCIAL FORECASTS AND PROJECTIONS TASK FORCE

NOTICE TO READERS

This guide was developed by the AICPA Financial Forecasts and Projections Task Force and has been reviewed by members of the AICPA Auditing Standards Board. Although the guide does not have the authority of a pronouncement by the Auditing Standards Board, AICPA members may be called upon to justify departures from it if their work is challenged.

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Preface

Prospective financial information is of interest to a broad spectrum of parties including security holders, potential investors, and the public. This guide represents another of the AICPA's efforts to provide information and guidance to those interested in prospective financial information. Nothing in this guide should be interpreted to mean that the publication of prospective financial information is recommended or that, if such information is published, an independent review and report is recommended.

Prospective financial information may take a number of different forms, such as forecasts, projections, feasibility studies, and budgets. Accountants may be engaged to provide a variety of services relating to prospective financial information, such as providing assistance in developing forecasting systems, identifying factors to be considered, and compiling or preparing the prospective information and carrying out independent reviews of such information. This guide deals with only one form of prospective information—financial forecasts—and only one type of accountant's service—independent review and reporting.

With a view toward providing guidance in additional areas, the AICPA is studying other forms of prospective financial information and other types of related services that accountants are engaged to perform. When an accountant is engaged for services other than the review of a financial forecast, his report should clearly describe the service provided and the degree of responsibility assumed. Such a report should be clearly distinguishable from a report on a review of a forecast as illustrated in this guide.

This guide is not intended to cover all aspects of performing feasibility studies, although feasibility studies often contain financial forecasts. If an accountant is engaged to review and report on a forecast included within a feasibility study, then this guide applies to that review and report.

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Chapter 1

Definitions and Responsibilities

Definitions

A variety of titles have been used to describe prospective financial information. In determining whether this guide applies, the accountant should consider the substance of the information presented rather than the title given to it. If the accountant concludes that the information being reviewed is a financial forecast, as defined below, that is the title that should be applied to the information.

A *financial forecast* for an entity is an estimate of the most probable financial position, results of operations, and changes in financial position for one or more future periods. In this context,

- *Entity* means any unit, existing or to be formed, for which financial statements could be prepared in conformity with generally accepted accounting principles or another comprehensive basis of accounting.
- *Most probable* means that the assumptions have been evaluated by management and that the forecast is based on management's judgment of the most likely set of conditions and its most likely course of action.[1] "Most probable" is not used in a mathematical or statistical sense.

Financial forecasts are distinguished from financial projections and feasibility studies:

- A *financial projection* for an entity is an estimate of financial results based on assumptions that are not necessarily the most

1. If the entity is to be formed in the future, the term "management" includes the promoters or other individuals responsible for directing the operations of the entity.

likely. Financial projections are often developed as a response to such questions as, What would happen if. . . ?

- A *feasibility study* is an analysis of a proposed investment or course of action. A feasibility study may involve the preparation of financial projections and/or a financial forecast, and an accountant who is engaged to review such a forecast should apply the provisions of this guide. A financial forecast may in turn be based on the results of a feasibility study used in the formulation of management's plans.

For purposes of this guide, a *forecasting process* includes any of the following:

- A formal system with a set of policies, procedures, methods, and practices used to prepare, monitor, and update forecasts.
- Performance of a work program that outlines the steps followed in the preparation of the forecast. (A nonrecurring forecast or a forecast for a new venture or small company is frequently prepared using a work program. A work program is ordinarily outlined at the beginning of the process and refined as the work progresses.)
- The documented procedures, methods, and practices used in the preparation of the forecast.

Background

The American Institute of Certified Public Accountants has issued two other documents containing guidance on financial forecasts: (*a*) *Guidelines for Systems for the Preparation of Financial Forecasts,* Management Advisory Services Guideline 3 (March 1975), issued by the AICPA Management Advisory Services Division and (*b*) *Statement of Position on Presentation and Disclosure of Financial Forecasts,* Statement of Position 75-4 (August 1975), issued by the AICPA Accounting Standards Division. These documents are presented as Appendixes A and B.

The Securities and Exchange Commission (SEC), which historically had prohibited the inclusion of prospective financial information in prospectuses and reports filed with it, now permits the publication of such information under certain conditions. In its releases on this subject, the SEC indicates that companies under its jurisdiction should not be required to include prospective financial information, but that those who choose to do so should meet certain broad standards and disclosure requirements. The SEC also adopted a safe-harbor rule for companies that issue prospective information (*a*) in good faith and (*b*) with a reasonable basis, and for third-party reviewers of such prospective information. The SEC releases are included as Appendix C.

Management's Responsibilities

The forecast including the underlying assumptions is the responsibility of an entity's management. Management cannot guarantee that forecasted results will be attained, because achievability depends on many factors that are outside management's control; however, management controls operations by planning, organizing, and directing activities. Management, therefore, is in the best position to develop reasonable assumptions with respect to the key factors upon which financial results depend.

Management may enlist the assistance of outside parties in preparing the forecast. For example, an accountant who is engaged to review and report on the forecast may provide such assistance by helping management identify assumptions, participating in information gathering, or performing the mechanical aspects of preparation. Such activities ordinarily would not affect the accountant's objectivity in reviewing and reporting on the forecast.[2] Regardless of the extent of the accountant's participation, the forecast assumptions remain management's responsibility. The accountant may assist management in the formulation of assumptions, but management must evaluate the assumptions, make key decisions, and present the assumptions as their own.

Accountant's Responsibilities

As required by the AICPA Code of Professional Ethics, an accountant should not permit his name to be used in conjunction with any forecast of future transactions in a manner that may lead to the belief that he vouches for its achievability. Additional guidance on the accountant's responsibilities is presented in the following chapters.

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2. Some of these services may not be appropriate if the accountant is to be named as a reviewer in a filing with the Securities and Exchange Commission. The SEC's Releases 33-5992 and 34-15305 on Guides 62 and 5 for Disclosure of Projections of Future Economic Performance state that, for forecasts filed with the commission, "a person should not be named as an outside reviewer if he actively assisted in the preparation of the projection."

Chapter 2

The Accountant's Review of a Financial Forecast

The objective of a review is to provide the accountant with a basis for reporting whether with respect to the forecast taken as a whole,

- The forecast was properly prepared based on the stated assumptions, and the presentation conforms with the recommendations in Statement of Position 75-4 (appropriately adapted when a comprehensive basis of accounting other than generally accepted accounting principles is used),[1] and
- The underlying assumptions provide a reasonable basis for management's forecast.

The accountant and management should agree on the objectives of the engagement and reach an understanding of the services to be provided. Ordinarily, this understanding should be confirmed in an engagement letter. (See exhibit 2-1 on page 13 for an illustrative engagement letter excerpt.)

The following guidelines apply to a review of a financial forecast and to the resulting report on that forecast:

1. The review should be performed by a person or persons with

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1. Guidance is provided in Statement on Auditing Standards 14 on the auditor's report when a comprehensive basis of accounting other than generally accepted accounting principles is used to serve as a framework for the historical financial statements. Accordingly, when the historical financial statements for the forecast period are expected to be prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles, the financial forecast should be prepared on that basis of accounting, and the specific information required to be presented (see Appendix B, Statement of Position 75-4, "Format") should be adapted as appropriate for the basis of accounting used.

adequate technical training and proficiency to review a financial forecast.

2. In all matters relating to the engagement, the accountant should maintain an independence in mental attitude.[2]
3. Due professional care should be exercised in the performance of the review and the preparation of the report.
4. The work should be adequately planned and assistants, if any, should be properly supervised.
5. The accountant should obtain an understanding of the forecasting process as a basis for determining the scope of the review.
6. Suitable support should be obtained to provide a reasonable basis for the accountant's report on the financial forecast.
7. The report based on the accountant's review should contain a statement regarding whether the accountant believes the financial forecast is presented in conformity with applicable AICPA guidelines for presentation of a financial forecast and has been prepared using assumptions that provide a reasonable basis for management's forecast.

The specific program of review should be developed giving consideration to the matters discussed below. (Exhibit 2-3 on page 15 illustrates possible review procedures.)

The Scope of the Review

Factors affecting the scope of the accountant's review include knowledge of the business, management's forecasting experience, the forecast period, and the forecasting process.

Knowledge of the Business. The accountant should obtain knowledge of the entity's business and the key factors upon which its future financial results depend, focusing on such areas as

a. Availability and cost of resources needed to operate. Principal

2. In making a judgment about whether he is independent, the accountant should be guided by the AICPA Code of Professional Ethics. Also see the auditing interpretation on "Applicability of Guidance on Reporting When Not Independent" (*AICPA Professional Standards*, vol. 1, AU Section 9504.19–22).

items usually include raw material, labor, short- and long-term financing, and plant and equipment.

b. The nature and condition of markets in which the entity sells its goods or services, including final consumer markets if the entity sells to intermediate markets.

c. Factors specific to the industry, including competitive conditions, sensitivity to economic conditions, accounting policies, specific regulatory requirements, and technology.

d. Patterns of past performance for the entity or comparable entities, including trends in revenue and costs, turnover of assets, uses and capacities of physical facilities, and management policies.

If the accountant has reviewed or examined the entity's historical financial statements or reviewed previous financial forecasts, he may be generally familiar with certain of these areas.[3] However, the accountant may acquire or augment this knowledge in other ways, such as by inquiry of entity personnel, by experience with similar entities in the industry, by consultation with individuals knowledgeable about the industry, and by use of industry publications, financial statements of other entities in the industry, textbooks, and periodicals.

Management's Forecasting Experience. Analysis of any forecasts developed for past periods compared to the historical results for those periods may indicate the effectiveness of the forecasting process. However, management's previous experience is not necessarily indicative of the reliability of the forecast under review.

Forecast Period. The accountant should consider the length of the period forecasted and the extent to which historical results are included in the forecast period.[4] These two factors may affect the amount and reliability of support for the assumptions underlying the forecast.

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3. See Statement on Auditing Standards 22, paragraphs 7–8, and Statement on Standards for Accounting and Review Services 1, paragraphs 24–26.

4. See Appendix B, Statement of Position 75-4, "Period to Be Covered."

Forecasting Process. The accountant's understanding of the entity's forecasting process helps determine the scope of the review. The accountant's initial understanding usually is obtained in discussion with management personnel responsible for the forecast. More detailed understanding, including the process by which the factors are identified and assumptions are developed, reviewed, and approved, is generally obtained through inquiry; observation; review of manuals, memoranda, instructions, and forms used (if any), analysis of models and statistical techniques (if used), and review of forecasting documentation. The extent to which the accountant obtains or develops documentation will depend upon the complexity of the forecasting process.

In determining the scope of his review of the forecast's underlying assumptions and presentation, the accountant should consider the forecasting process in relation to the guidance in Management Advisory Services Guideline 3 (see Appendix A).[5]

Procedures to Evaluate Assumptions

Generally, management's assumptions are readily identifiable from (1) the summary of significant forecast assumptions and (2) analysis of the more detailed data included in the forecast documentation. The accountant should perform those procedures he considers necessary in the circumstances to enable him to report on whether he believes the assumptions provide a reasonable basis for management's forecast. Based on his review, the accountant can conclude that the assumptions provide a reasonable basis for the forecast, if he concludes (1) that management has explicitly identified the factors expected to materially affect the operations of the entity during the forecast period and has developed appropriate assumptions with respect to such factors [6] and (2) that the assumptions are suitably supported.

Identification of Key Factors. Using his knowledge of the busi-

5. The accountant's consideration of the forecasting process may also provide a basis for constructive suggestions concerning improvements in the forecasting process.

6. An attempt to list all assumptions is inherently not feasible. Frequently, basic assumptions that have enormous potential impact are considered to be implicit, such as conditions of peace and absence of natural disasters.

ness, the accountant should evaluate whether management's assumptions relate to all key factors upon which the entity's financial results depend. In evaluating the assumptions, the accountant should consider the relevance and overall completeness of the factors identified as well as risks inherent in the business, the sensitivity of the forecast to variations in particular factors, and the pervasiveness of the particular factors in the various assumptions. These matters may significantly affect the forecast because of their importance in one or more significant assumptions.

Analyzing prior-period financial statements may help identify the principal factors that influence financial results. The accountant should consider whether any significant deviations from historical trends exist, including deviations evident in interim historical results included for a part of the forecast period. The deviation might highlight a significant factor that was not deemed important to the business previously.

Support for Assumptions. Having satisfied himself that the key factors have been identified and included in the assumptions, the accountant should evaluate whether the assumptions are suitably supported. In his evaluation, the accountant should consider the assumptions in the aggregate as a basis for the forecast. If certain assumptions have no material impact on the forecast, they may not have to be individually evaluated. Nonetheless, the accountant should consider the aggregate impact of individually insignificant assumptions in evaluating whether the assumptions are reasonable.

A forecast is defined in terms of management's estimate of the most probable outcome. *Most probable* means that the assumptions have been evaluated by management and that the forecast is based on management's judgment of the most likely set of conditions and its most likely course of action. Although the accountant can reach a conclusion that the assumptions provide a reasonable basis for the forecast, he cannot conclude that any outcome is most probable because (*a*) realization of the forecast may depend upon management's intentions, which cannot be reviewed, (*b*) there is substantial inherent uncertainty in forecast assumptions, and (*c*) some of the information accumulated about an assumption may appear contradictory. Different but similarly reasonable assumptions concerning a particular matter might be derived from common information. However, if the preponderance of information supports each significant assumption, a basis exists for reporting a belief that the assumptions provide a reasonable basis for management's forecast.

The accountant should concentrate his effort on specific assumptions that are

- Material to the forecasted amounts
- Especially sensitive to variations
- Deviations from historical trends
- Especially uncertain

In evaluating whether the assumptions are suitably supported, the accountant should consider the following matters:

1. Whether sufficient pertinent sources of information about the assumptions have been considered. Examples of external sources the accountant might consider are government publications, industry publications, economic forecasts, existing or proposed legislation, and reports of changing technology. Examples of internal sources are budgets, labor agreements, patents, royalty agreements, engineering studies, historical financial statements and records, sales backlog records, debt agreements, and board of directors actions involving entity plans.
2. Whether the assumptions are consistent with the sources from which they are derived.
3. Whether the assumptions are consistent with each other.
4. Whether the historical financial information and other data used in developing the assumptions are sufficiently reliable for that purpose. Reliability can be assessed by inquiry or by analytical or other procedures, some of which may have been completed in past examinations or reviews of the historical financial statements.
5. Whether the historical financial information and other data used in developing the assumptions are comparable over the periods specified or whether the effects of any lack of comparability were considered in developing the assumptions.
6. Whether the logical argument or theory, considered with the data supporting the assumptions, is reasonable.

Support for assumptions may include market surveys, engineering studies, general economic indicators, industry statistics, trends and patterns developed from an entity's operating history, and internal data and analyses, accompanied by their supporting logical argument or theory. The accountant may also obtain support during the evaluation of the forecasting process. Support for a forecast can range from information based on informed opinion (such as economists' estimates of the inflation rate) to data that can be tested in traditional ways (such as completed transactions).

In addition to evaluating management's assumptions and their sources of information, the accountant should consider using alternative approaches to the development of assumptions in evaluating the forecasted amounts. For example, to test management's forecast of aggregate sales developed from individual salesmen's estimates, the accountant may employ a historical trend estimate.

Procedures to Evaluate the Preparation and Presentation of the Forecast

In evaluating the preparation and presentation of the forecast, the accountant should perform procedures that will provide reasonable assurance of the following:

1. The forecast reflects the identified assumptions.
2. The computations made to translate the assumptions into forecasted amounts are mathematically accurate.
3. The assumptions are internally consistent.
4. Accounting principles used in the forecast are consistent with the generally accepted accounting principles (or other comprehensive basis of accounting) expected to be used in the historical financial statements covering the forecast period(s), and those used in the most recent historical financial statements, if any.
5. The presentation of the forecast follows the guidelines in Statement of Position 75-4.
6. The assumptions have been adequately disclosed, based upon the guidelines in Statement of Position 75-4.

The accountant should consider whether the forecast, including related disclosures, should be revised because of (*a*) mathematical errors, (*b*) unreasonable assumptions, (*c*) inappropriate or incomplete presentation, or (*d*) inadequate disclosure.

Management's Written Representations

The accountant should obtain written representations from management acknowledging management's responsibility for both the forecast and the underlying assumptions. Such representations should include a statement that the financial forecast is management's estimate of the most probable financial position, results of operations, and changes in financial position for the forecast period and that the forecast reflects management's judgment, based on present circumstances, of the most likely set of conditions and its most likely course of action. The representations should be signed by members of management whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations. Exhibit 2-2 on page 14 is an illustrative representation letter.

Historical Financial Results

If historical financial statements have been prepared for an expired part of a forecast period, the accountant should consider the historical data in relation to the forecasted results for the same period. If the forecast incorporates the historical financial results and that period is significant to the forecast, the accountant should make a review of the historical information in conformity with applicable standards for a review.[7]

Using the Work of a Specialist

During review of the forecast, the accountant may encounter matters that in his judgment require using the work of a special-

7. If the entity is a public company, the accountant should perform the procedures in Statement on Auditing Standards 24, *Review of Interim Financial Information*, paragraphs 6–15. If the entity is nonpublic, the accountant should perform the procedures in Statement on Standards for Accounting and Review Services 1, *Compilation and Review of Financial Statements*, paragraphs 24–31.

ist. Although the guidance provided in Statement on Auditing Standards 11 is intended for the auditor of historical financial statements, it is generally applicable when the accountant reviewing a forecast uses the work of a specialist.

Working Papers

Working papers should be appropriate to the circumstances and the accountant's needs on the engagement to which they apply. Although the quantity, type, and content of working papers vary with the circumstances, they generally would indicate

1. That the engagement had been planned and that the work of assistants had been supervised and reviewed.
2. That the entity's forecasting process had been considered in determining the scope of the review.
3. What sources of information were used and the major assumptions that were made in the preparation of the forecast.
4. The accountant's procedures in evaluating (*a*) whether the assumptions and forecasted financial information were suitably supported, and (*b*) whether the forecast was appropriately prepared and presented.

Exhibit 2-1

Illustrative Engagement Letter Excerpt

This letter confirms our understanding of the arrangements for our review of the financial forecast of (name of entity) for the (period), for the purpose of issuing a report stating whether we believe (1) your financial forecast is presented in conformity with applicable guidelines established by the American Institute of Certified Public Accountants for presentation of a financial forecast and (2) your assumptions provide a reasonable basis for your forecast.

It should be noted that management is responsible for representations about its plans and expectations and for disclosure of significant information that might affect the ultimate realization of the forecasted results.

Our review will be made in accordance with applicable guidelines of the American Institute of Certified Public Accountants for a review of a financial forecast and, accordingly, will include procedures to evaluate (*a*) the assumptions used by management as a basis for the financial forecast, (*b*) the preparation of the financial forecast, and (*c*) the presentation of the financial forecast.

We have no responsibility to update our report for events and circumstances occurring after the date of our report.

Some assumptions inevitably will not materialize, and unanticipated events and circumstances may occur; therefore, the actual results achieved during the forecast period will vary from the forecast, and the variations may be material. Our report will contain a statement to that effect.

Our report will detail the nature of reservations (if any) we have with respect to the forecast. Should any such reservations develop, we will discuss them with you before the report is issued.

If you intend to reproduce and publish the forecast and our report thereon, they must be reproduced in their entirety and both the first and subsequent corrected drafts of the forecast and any material that accompanies the forecast must be submitted to us for approval.

Exhibit 2-2

Illustrative Representation Letter

The following letter is presented for illustrative purposes only. The written representations to be obtained should be based on the circumstances of the engagement.

(Date of Accountant's Report)

(To Accountant)

In connection with your review of the (identification of financial forecast) of (name of entity) as of (date) and for the (period), we make the following representations:

1. The financial forecast presents our estimate of the most probable financial position, results of operations, and changes in financial position for the period, in accordance with the generally accepted accounting principles expected to be used by the company during the forecast period, which are consistent with the principles that (name of entity) uses in preparing its historical financial statements.
2. The financial forecast is based on our judgment of the most likely set of conditions and our most likely course of action.
3. We have made available to you all significant information that we believe is relevant to the forecast.
4. We believe that the assumptions underlying the forecast are reasonable and appropriate.

5. To the best of our knowledge and belief, the documents and records supporting the assumptions are appropriate and reliable.
6. We believe the forecasted results are achievable; however, the forecast may be favorably or unfavorably affected by many unforeseeable and uncontrollable factors.

(Signatures)

Exhibit 2-3

Illustrative Review Procedures

The following procedures are listed to assist the accountant in planning reviews of financial forecasts. The list is neither a complete summary of all possible procedures, nor an outline of minimum procedures, but it should aid in the development and selection of procedures for a particular engagement.

The procedures are divided into three categories:

- Procedures to determine the scope of the review.
- Procedures to evaluate assumptions.
- Procedures to evaluate the preparation and presentation of the forecast.

Procedures to Determine the Scope of the Review

1. Obtain the forecast, together with a list of the significant assumptions and their descriptions.
2. Obtain knowledge of the entity's business by
   - Interviewing entity personnel and other individuals knowledgeable about the industry.
   - Consulting AICPA guides, industry publications, textbooks, and periodicals.
   - Analyzing financial statements of the entity and of other entities in the industry.

   The accountant may have previously obtained some of this knowledge through experience with the entity or its industry.
3. Obtain, prepare, or update an analysis of the following items:
   - Resources needed by the company (availability and cost).
     - Material
     - Labor
     - Capital
     - Fixed assets (e.g., capacity of plant and equipment)
   - Markets served by the company (nature and condition).
     - Intermediate markets

Final consumer markets
Entity's market share
Advertising and marketing plans

- Factors specific to the industry.
  Competitive conditions
  Sensitivity to economic conditions
  Accounting policies
  Specific regulatory requirements
  Technology
- Patterns of past performance for the entity or comparable entities.
  Trends in revenue and costs
  Turnover of assets
  Uses and capacities of physical facilities
  Management policies

4. Review the process used in preparing the forecast to obtain an understanding of the rationale by which key factors are identified and assumptions are developed and of the process by which assumptions are translated into forecast data. The accountant would look for answers to such questions as these:
   - Is preparation of the forecast adequately documented to permit tracing through the process? The accountant may decide to prepare a brief outline of the forecasting process used.
   - If the process has been used in the past to generate previous forecasts, was it effective?
   - What procedures provide reasonable assurance that all significant factors are identified and included in the assumptions?
   - What procedures provide reasonable assurance that the forecast is based on assumptions approved by management?
   - What are the methods for collecting, calculating, and aggregating forecast data?
   - What methods identify and quantify the impact of variations in assumptions?
   - What accounting principles are used in the forecast?
   - Are there procedures to reflect changes in accounting principles in the forecast?
   - If the forecasting process has been in operation or used in the past, are there procedures to compare prior forecasted amounts with the historical results for the same period and analyze the differences (for example, differences in forecasted amounts and actual results should be analyzed to ascertain that identified causes are considered)? Are the procedures used to adjust the forecasting process, where applicable, as a result of such analysis?
   - What are management's review and approval procedures?
   - How are errors prevented or detected?

5. Identify any forecasting models and techniques that are used. If possible, obtain a description of them.
6. Having reviewed the forecasting process, analyze its strengths and weaknesses, comparing it with the guidelines outlined in Management Advisory Services Guideline 3.
7. Consider the competence of management personnel involved in the forecasting process, including their degree of authority, prior experience with the entity and industry, and understanding of both the company plans and the forecasting process, in relation to their functions in the process and in entity operations.
8. Review documentation of both the forecast and the forecasting process, or otherwise investigate whether there is
   - Review and approval by management.
   - Determination of the relative effect of variations in major underlying assumptions.
   - Use of the appropriate accounting principles and practices.
9. Test significant elements of the forecasting process designed to prevent or detect errors, including clerical compilation errors.
10. Review the entity's documentation of the comparison of actual results with previously forecasted amounts (if any) and consider (*a*) whether the comparison was performed using correct, comparable data and whether analyzed differences were documented and appropriately supported, (*b*) whether the forecasting process was adjusted where appropriate, (*c*) whether the forecasting procedures have in the past reflected the entity's plans properly, and (*d*) whether any consistent biases have been observed.
11. Based on the knowledge obtained in the foregoing procedures, design the review procedures for evaluating assumptions and evaluating the preparation and presentation of the forecast.

Procedures to Evaluate Assumptions

1. Identify key factors upon which the financial results of the entity depend.
   - Evaluate both the assumptions listed in the forecast and the more detailed data included in the forecast documentation to determine the completeness of the list. Factors to consider include
     Risks inherent in the business.
     Sensitivity of the forecast to variations.
     Pervasiveness of the impact of particular factors on the various assumptions.
   - Obtain forecasts of similar businesses, if available, and consider whether the key factors covered by the assumptions therein are covered in the client's forecast.

- Analyze prior-period financial results to help identify the principal factors that influenced the results. If any interim historical results are available, consider any significant deviations from historical patterns and investigate the causes.
- Review any public statements, formal plans, and the minutes of board of directors meetings, noting any significant decisions regarding plans, contracts, or legal agreements.
- Question management regarding possible additional factors or changes in assumptions about factors.
- Using knowledge of the entity and its industry, investigate any particularly risky or sensitive aspect of the business—market trends, competitive conditions, pending laws and regulations, social, economic, political and technological influences, and dependence upon major customers and suppliers.

2. Evaluate whether the assumptions are suitably supported.
   - Evaluate the support for the assumptions, giving special attention to specific assumptions that are
     Material to the forecast values
     Especially sensitive to variations
     Deviations from historical patterns
     Especially uncertain
   - For key assumptions, obtain a list of internal and external sources of information that the entity used in formulating the assumptions. On a test basis, evaluate whether the information was considered in formulating the assumptions.
   - Trace assumptions about selected key factors to the support for the assumptions to determine whether the indicated sources of information were actually used and to evaluate the suitability of existing support. If the information is taken from management's internal analyses, consider the need for testing the supporting information.
   - Review any available reflection of management's plans, such as budgets, spending estimates, policy statements, contractual agreements, etc., and inquire about those plans, goals, and objectives and consider their relationship to the assumptions.
   - Investigate alternative sources of support for the assumptions and evaluate whether the preponderance of accumulated information supports each assumption.*
   - Inquire about and analyze the historical data used in developing forecasted amounts, to assess
     Whether it is comparable and consistent over the periods specified.

* The cost to acquire the additional information should be commensurate with anticipated benefits. See Appendix A, Management Advisory Services Guideline 3, guideline no. 4.

Whether it is sufficiently reliable for the purpose.

- If historical financial statements have been prepared for an expired part of the forecast period, read the historical data and consider them in relation to the forecasted results for the same period.
- If the forecast incorporates the historical financial results and that period is significant to the forecast, make a review of the historical information in conformity with applicable standards for a review.
- Consider alternative approaches to the development of the assumptions. For example, if the sales assumption was developed by aggregating individual salesmen's estimates, consider comparing the assumption to historical patterns. Also consider trying other forecasting models and techniques.
- Evaluate whether the forecast extends to time periods for which suitable support for assumptions is not available, considering
  The nature of the entity's industry.
  Patterns of past performance for the entity or comparable entities.
- Where appropriate, consider confirming with external sources information supporting the assumptions (for example, if the backlog of orders is significant to the forecast and is not adequately supported, consider sending written confirmation requests to customers).
- If the support for key assumptions comes from experts such as lawyers, engineers, economists, investment bankers, and architects,
  Consider their professional standing.
  Consider using the work of another expert in the field.
  Consider the need to obtain the expert's permission to rely on his work supporting the assumption, as of the forecast date.
  Review the data and plans submitted by the entity to the expert for consistency with the forecast and supporting data.
- Obtain a representation letter from entity management.
- Consider obtaining a letter from the client's legal counsel, as of the report date, covering
  Litigation, claims, and assessments.
  Legality of any major changes planned (such as marketing considerations, environmental impact, or patents) and other matters (such as the impact of new laws affecting the industry).

Procedures to Evaluate the Preparation and Presentation of the Forecast

1. Test the mathematical accuracy of the computations made in translating the assumptions into forecasted amounts.
2. Evaluate whether data have been appropriately aggregated by
   - Evaluating the appropriateness of mathematical equations, statistical techniques, and modeling procedures.

- Recomputing on a test basis.
- Tracing aggregate amounts to the final forecast.

3. Determine whether the listed assumptions are those used in preparing the forecast.
4. Determine whether the effects of each assumption on all of the related forecast amounts have been reflected in the forecast.
5. Determine whether any assumption contradicts or is inconsistent with another.
6. Review the relationship between financial and other relevant data using appropriate mathematical or judgmental methods.
7. Review adjustments made in the data, considering whether they are justified and reasonable in relation to other information, and whether their impact has been properly reflected in the forecast.
8. If historical data are included in the forecast, trace the amounts from the books, records, and other indicated sources to the final forecast.
9. Determine whether the presentation is in conformity with the presentation guidelines in Statement of Position 75-4, considering the following:
   - Is the forecast presented in the format of the historical financial statements expected to be issued? If not, are the minimum items presented?
   - Are the accounting principles used
     - Consistent with those used in the historical financial statements, if any?
     - Consistent with those expected to be used in future financial statements (including expected changes in accounting principles)?
     - Generally accepted accounting principles (or another comprehensive basis of accounting)?
   - Is the forecast expressed in specific monetary amounts?
   - Are the assumptions adequately disclosed?
   - Is the relative impact of a variation disclosed for each material, sensitive assumption?
   - If the impact of a variation in an assumption is disclosed, is it appropriately stated?
   - Are the forecasted statements appropriately distinguished from historical financial statements?

Chapter 3

The Accountant's Report on a Reviewed Financial Forecast

Accountant's Standard Report

The accountant's standard report on a review of a financial forecast should include

1. An identification of the forecast information presented by management and a description of what it is intended to represent.
2. A statement that the review was made in accordance with applicable AICPA guidelines for a review of a financial forecast and a brief description of the nature of such a review.
3. A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.
4. A statement regarding whether the accountant believes that the financial forecast is presented in conformity with applicable AICPA guidelines for presentation of a financial forecast and whether the underlying assumptions provide a reasonable basis for management's forecast.[1]
5. A caveat regarding the ultimate attainment of the forecasted results.

1. The accountant's report need not comment on the consistency of the application of accounting principles as long as the presentation of any change in accounting principles is in conformity with the guidelines in Statement of Position 75-4.

The form of the standard report is as follows.

> The accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position, and summary of significant forecast assumptions [2] of XYZ Company as of December 31, 19XX, and for the year then ending, is management's estimate of the most probable financial position, results of operations, and changes in financial position for the forecast period. Accordingly, the forecast reflects management's judgment, based on present circumstances, of the most likely set of conditions and its most likely course of action.
>
> We have made a review of the financial forecast in accordance with applicable guidelines for a review of a financial forecast established by the American Institute of Certified Public Accountants. Our review included procedures to evaluate both the assumptions used by management and the preparation and presentation of the forecast. We have no responsibility to update this report for events and circumstances occurring after the date of this report.
>
> Based on our review, we believe that the accompanying financial forecast is presented in conformity with applicable guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants. We believe that the underlying assumptions provide a reasonable basis for management's forecast. However, some assumptions inevitably will not materialize and unanticipated events and circumstances may occur; therefore, the actual results achieved during the forecast period will vary from the forecast, and the variations may be material.

The date of completion of the accountant's review procedures should be used as the date of the report. The report may also present other information and comments the accountant wishes to include, such as details of the items in the forecasted statements, statistical data, explanatory comments, or other informative material.

Circumstances Resulting in Departure From Accountant's Standard Report

The circumstances that result in a departure from the accountant's standard report are as follows:

1. The accountant believes that the forecast departs from the presentation guidelines discussed in Statement of Position 75-4. (See p. 23.)

2. When the presentation of the forecast is summarized (see Appendix B, Statement of Position 75-4, "Format"), this sentence might read, "The accompanying financial forecast of XYZ Company, including the summary of significant forecast assumptions. . . ."

2. The accountant believes one or more significant assumptions are unreasonable. (See p. 24.)
3. The scope of the accountant's review is affected by conditions that preclude application of one or more procedures he considers necessary in the circumstances. (See p. 24.)
4. The accountant is not independent. (See p. 26.)
5. The accountant's evaluation is based in part on the report of another accountant. (See p. 26.)
6. Historical financial information is presented for comparison to the forecast. (See p. 27.)
7. The accountant wishes to emphasize a matter regarding the financial forecast. (See p. 27.)

Because of the nature, sensitivity, and interrelationship of forecasted information, a reader would find a qualified accountant's report difficult to interpret. Accordingly, the accountant should not express conclusions about the forecast's conformity with applicable guidelines or the reasonableness of its underlying assumptions with language such as "except for. . . ." or "subject to the effects of. . . ." Rather, when a departure from the guidelines, an unreasonable assumption, or a limitation on the scope of the accountant's review has led him to conclude that he cannot issue an unqualified report, he should issue the appropriate type of report described in this section.

Adverse Report. An adverse report states that the accountant believes that the financial forecast has not been presented in conformity with AICPA guidelines. When an adverse report is issued, the concluding paragraph should include a direct reference to the specific paragraph that discloses the basis for the adverse report.

The following circumstances result in an adverse report:

1. The accountant believes that the forecast departs from the presentation guidelines discussed in Statement of Position 75-4.
2. The accountant believes one or more significant assumptions are unreasonable.

Departure From the Presentation Guidelines. When the accountant has made a review in accordance with this guide and he believes that the forecast is materially affected by a departure from the presentation guidelines of Statement of Position 75-4 (appropriately adapted when a comprehensive basis of accounting other than generally accepted accounting principles is used), he should issue an adverse report.

If the forecast, including the summary of significant forecast assumptions, fails to disclose assumptions that, at the time of forecast presentation, appear to be significant, the accountant should describe the assumptions in his report.

Unreasonable Assumption(s). If the accountant believes one or more significant assumptions to be unreasonable, he should issue an adverse report. A separate paragraph in the accountant's report should state the reasons for his conclusion, and the concluding paragraph should state that the accountant believes that the assumptions do not provide a reasonable basis for management's forecast.

Form of Adverse Report. The following is an example of an adverse report to be issued when the accountant believes a significant assumption is unreasonable.

(Explanatory Paragraph)

As discussed under the caption "Sales" in the summary of significant forecast assumptions, the forecasted sales include, among other things, revenue from the company's federal defense contracts continuing at the current level. The company's present federal defense contracts will expire in March 19XX. No new contracts have been signed and no negotiations are under way for new federal defense contracts. Furthermore, the federal government has entered into contracts with another company to supply the items being manufactured under the company's present contracts.

(Concluding Paragraph)

Based on our review, we believe that the accompanying financial forecast is not presented in conformity with applicable guidelines established by the American Institute of Certified Public Accountants because management's assumptions, as discussed in the preceding paragraph, do not provide a reasonable basis for management's forecast.

Scope Limitation. The accountant can issue an unqualified report only if the review has been conducted in accordance with this guide and he has been able to apply all the procedures he considers necessary in the circumstances. The scope of the accountant's review may be limited either (*a*) by client-imposed conditions that preclude the application of one or more procedures that the accountant considers necessary in the circumstances to comply with the guidelines set forth in this guide or (*b*) by circumstances, such as the accountant's inability to evaluate significant assumption(s) because they are not suitably supported. Limitations on the scope of the review, whether imposed by the client or by other circumstances, may require the accountant to state in his report that he cannot evaluate the presentation of the forecast or assess whether the assumptions provide a reasonable basis for management's forecast.

If the accountant does not believe an assumption(s) to be suitably supported, the accountant should assess its effect on the interrelationships of assumptions and on the forecast taken as a whole.

If management restricts the scope of the accountant's procedures or declines to develop the information he considers necessary to evaluate one or more significant assumptions, the accountant generally should issue a report describing a scope limitation.

The accountant's report should indicate in a separate paragraph(s) the respects in which the review did not comply with this guide. The accountant should state that the scope of the review was not sufficient to enable him to express a conclusion with respect to the forecast presentation, and the concluding paragraph should include a direct reference to the explanatory paragraph(s).

The following is an example of a report on a forecast for which a significant assumption could not be evaluated:

(Second Paragraph)

We have made a review of the financial forecast. Except as explained in the following paragraph, our review was made in accordance with applicable guidelines for a review of a financial forecast established by the American Institute of Certified Public Accountants.

(Explanatory Paragraph)

As discussed under the caption "Income From Investee" in the summary of significant forecast assumptions, the forecast includes income from an equity investee constituting 23 percent of forecasted net income, based on the assumption that income from the investee will equal that of 19X1. The investee has not prepared a financial forecast for the year ending December 31, 19X2, and we were therefore unable to inspect suitable support for this assumption.

(Concluding Paragraph)

Since, as described in the preceding paragraph, we are unable to evaluate management's assumption regarding income from an equity investee and other assumptions that depend thereon, we express no conclusion with respect to the presentation of the accompanying financial forecast.

When there is a scope limitation and the accountant also believes there are material departures from the presentation guidelines of Statement of Position 75-4, those departures should be described in the accountant's report.

Lack of Independence. Whether or not the accountant is independent is something he must decide as a matter of professional judgment. When the accountant is not independent, he should state in his report that he expresses no conclusion with respect to the forecast and should also state specifically that he is not independent. However, the reason for lack of independence should not be described; including the reason may confuse the reader concerning the importance of impairment of independence. Following is an example of a report to be issued when the accountant is not independent:

We are not independent with respect to XYZ Company, and the accompanying forecasted balance sheet as of December 31, 19XX, forecasted statements of income, retained earnings, and changes in financial position for the year then ending, and the summary of significant forecast assumptions were not reviewed by us in accordance with applicable guidelines for a review of a financial forecast established by the American Institute of Certified Public Accountants. Accordingly, we express no conclusion with respect to the accompanying financial forecast.

Evaluation Based in Part on Report of Another Accountant. When more than one accountant is involved in the review of a forecast, the guidance provided for that situation in examinations of historical financial statements is generally applicable. When the principal accountant decides to refer to the report of another accountant as a basis, in part, for his own report, he should disclose that fact in stating the scope of the review and should refer to the report of the other accountant in the concluding paragraph of the report. These references indicate division of responsibility for performance of the review.

Comparative Historical Financial Information. When historical financial information is presented for comparison to the forecast and is part of the forecast presentation, the accountant's report should (*a*) contain a clear-cut indication of the character of the work performed, if any, and the degree of responsibility the accountant is taking for the historical information and (*b*) refer to the source of the information and the accountant's report, if any, issued previously.

An example of a report to be issued when the comparative historical information was summarized from financial statements previously examined or reviewed by the accountant is presented below.

(Second Paragraph)

> . . . The summarized historical financial information presented with the forecast for comparative purposes is taken from the financial statements of XYZ Company for the year ended December 31, 19X1, which we examined (reviewed) as indicated in our report dated March 1, 19X2. . . .

An example of the reference to the auditor's report when that report was qualified follows:

> . . . Our report dated March 1, 19X2, was qualified as being subject to the effects on the 19X1 financial statements of such adjustments, if any, as might have been required had the outcome of certain litigation, discussed in the summary of significant forecast assumptions under the caption "Litigation," been known. . . .

The forecast may be included in a document that also contains the historical financial statements and the auditor's report. An example of the reference to the auditor's report on the comparative historical financial information when examined by the same accountant is presented below.

(Second Paragraph)

> . . . The historical financial statements and our report are set forth on pages xx-xx of this document. . . .

Emphasis of a Matter. In some circumstances, the accountant may wish to emphasize a matter regarding the forecast but, nevertheless, intends to issue an unqualified report. Such information may be presented in a separate paragraph of the accountant's report.

Chapter 4

Illustrative Financial Forecast

The following is an illustration of a financial forecast presented in conformity with Statement of Position 75-4 (included in this guide as Appendix B) and the accountant's report based on his review of the forecast. This illustration is consistent with the guidance established by the American Institute of Certified Public Accountants, although other presentation formats could also be consistent. Its appropriateness for a particular situation depends upon the circumstances, and readers should exercise care in using the sample financial forecast as a guide for wording, style, or format.

Accountant's Report

(Accountant's Letterhead)

The accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position, and summary of significant forecast assumptions of XYZ Company as of December 31, 19X3, and for the year then ending, is management's estimate of the most probable financial position, results of operations, and changes in financial position for the forecast period. Accordingly, the forecast reflects management's judgment, based on present circumstances, of the most likely set of conditions and its most likely course of action.

We have made a review of the financial forecast in accordance with applicable guidelines for a review of a financial forecast established by the American Institute of Certified Public Accountants. Our review included procedures to evaluate both the assumptions used by management and the preparation and presentation of the forecast. The summarized historical financial information presented with the forecast for comparative purposes is taken from the financial statements of XYZ Company for the years ended December 31, 19X2 and 19X1, which we examined. The historical financial statements and our report are set forth on pages xx-xx of this document.* We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Based on our review, we believe that the accompanying financial forecast is presented in conformity with applicable guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants. We believe that the underlying assumptions provide a reasonable basis for management's forecast. However, some assumptions inevitably will not materialize and unanticipated events and circumstances may occur; therefore, the actual results achieved during the forecast period will vary from the forecast, and the variations may be material.

(Accountant's Signature)

February 17, 19X3

* These exhibits are not included in this guide.

XYZ Company, Inc.

Forecasted Statement of Income and Retained Earnings

Year Ending December 31, 19X3

(in thousands)

	Forecasted	*Comparative historical information*	
	19X3	*19X2*	*19X1*
Net sales	$101,200	$91,449	$79,871
Cost of sales	77,500	70,140	60,463
Gross profit	23,700	21,309	19,408
Selling, general, and administrative expenses	15,100	13,143	11,014
Operating income	8,600	8,166	8,394
Other income (deductions):			
Miscellaneous	1,700	964	(308)
Interest expense	(2,400)	(1,914)	(1,943)
	(700)	(950)	(2,251)
Income before income taxes	7,900	7,216	6,143
Income taxes	3,400	3,267	2,929
Net income for the year	4,500	3,949	3,214
Retained earnings at beginning of year	10,500	7,803	5,543
Dividend (per share 19X3: $1.50; 19X2: $1.35; 19X1: $1.00)	(1,400)	(1,288)	(954)
Retained earnings at end of year	$ 13,600	$10,464	$ 7,803
Earnings per share (in dollars)	$ 4.80	$ 4.14	$ 3.37

See accompanying Summary of Significant Forecast Assumptions and Summary of Significant Accounting Policies.

XYZ Company, Inc.

Forecasted Statement of Changes in Financial Position
Year Ending December 31, 19X3

(in thousands)

	Forecasted	*Comparative historical information*	
	19X3	*19X2*	*19X1*
Sources of working capital			
Net income	$ 4,500	$ 3,949	$3,214
Depreciation, which does not use working capital	2,800	2,422	2,181
Working capital provided by operations	7,300	6,371	5,395
Proceeds from long-term borrowings	6,000	4,100	2,000
	$13,300	$10,471	$7,395
Uses of working capital			
Dividend	$ 1,400	$ 1,288	$ 954
Current installments and repayment of long-term debt	2,600	3,800	2,300
Additions to plant and equipment	4,400	2,907	2,114
Increase in other assets	2,200	600	83
Increase in working capital	2,700	1,876	1,944
	$13,300	$10,471	$7,395
Changes in components of working capital			
Increase (decrease) in current assets			
Cash	$ 1,500	$ (334)	$1,017
Accounts receivable	2,500	1,430	483
Inventory	100	3,995	1,431
Other	1,700	350	62
	5,800	5,441	2,993
Increase (decrease) in current liabilities			
Notes payable to bank	1,500	100	(300)
Accounts payable and accrued expenses	1,100	1,696	846
Current installments of long-term debt	400	958	342
Other	100	811	161
	3,100	3,565	1,049
Increase in working capital	$ 2,700	$ 1,876	$1,944

See accompanying Summary of Significant Forecast Assumptions and Summary of Significant Accounting Policies.

XYZ Company, Inc.

Forecasted Balance Sheet

December 31, 19X3

(in thousands)

	Forecasted	*Comparative historical information*	
	19X3	*19X2*	*19X1*
Assets			
Current assets			
Cash	$ 3,300	$ 1,862	$ 2,196
Accounts receivable (net)	14,900	12,438	11,008
Inventory	27,000	26,932	22,937
Other	3,500	1,813	1,463
Total current assets	48,700	43,045	37,604
Property, plant, and equipment	30,900	26,915	22,832
Less accumulated depreciation	17,300	14,912	11,314
Net property, plant, and equipment	13,600	12,003	11,518
Other assets	5,000	2,714	2,114
	$67,300	$57,762	$51,236
Liabilities and Stockholders' Equity			
Current liabilities			
Notes payable to bank	$ 4,600	$ 3,100	$ 3,000
Accounts payable and accrued expenses	12,300	11,193	9,497
Current installments of long-term debt	4,400	3,968	3,010
Other	900	925	114
Total current liabilities	22,200	19,186	15,621
Long-term debt, excluding current installments	20,100	16,700	16,400
Stockholders' equity			
Capital stock	11,400	11,412	11,412
Retained earnings	13,600	10,464	7,803
Total stockholders' equity	25,000	21,876	19,215
	$67,300	$57,762	$51,236

See accompanying Summary of Significant Forecast Assumptions and Summary of Significant Accounting Policies.

The three preceding presentations represent the preferred format for a financial forecast as recommended in Statement of Position 75-4. However, the statement allows a more summarized presentation if certain minimum specific information obtained from a financial forecast is disclosed. (See Appendix B.) Following is a summarized presentation that could be used in lieu of the preceding three presentations (accountant's report not illustrated).

XYZ Company, Inc.

Summarized Financial Forecast

Year Ending December 31, 19X3

(in thousands)

	Forecasted	*Comparative historical information*	
	19X3	*19X2*	*19X1*
Sales	$101,200	$91,449	$79,871
Gross profit	$ 23,700	$21,309	$19,408
Income tax expense	$ 3,400	$ 3,267	$ 2,929
Net income	$ 4,500	$ 3,949	$ 3,214
Earnings per share (in dollars)	$ 4.80	$ 4.14	$ 3.37
Significant anticipated changes in financial position			
Working capital provided by operations	$ 7,300	$ 6,371	$ 5,395
Proceeds from long-term borrowings	$ 6,000	$ 4,100	$ 2,000
Dividend payment (per share 19X3: $1.50; 19X2: $1.35; 19X1: $1.00)	$ 1,400	$ 1,288	$ 954
Additions to plant and equipment	$ 4,400	$ 2,907	$ 2,114
Increase in working capital	$ 2,700	$ 1,876	$ 1,944

See accompanying Summary of Significant Forecast Assumptions and Summary of Significant Accounting Policies.

XYZ Company, Inc.

Summary of Significant Forecast Assumptions for the Year Ending December 31, 19X3

This financial forecast is management's estimate of the most probable financial position, results of operations, and changes in financial position for the forecast period. Accordingly, the forecast reflects management's judgment based on present circumstances of the most likely set of conditions and its most likely course of action. The assumptions disclosed herein are those that management believes are significant to the forecast or are key factors upon which the financial results of the company depend. Some assumptions inevitably will not materialize, and unanticipated events and circumstances may occur subsequent to February 17, 19X3, the date of this forecast. Therefore, the actual results achieved during the forecast period will vary from the forecast, and the variations may be material. The comparative historical information for 19X1 and 19X2 is extracted from the company's financial statements for those years, presented on pages xx–xx. The financial statements should be read for additional information.

a. *Sales.* The overall market for the company's products has grown over the past five years at an average rate of 2 percent above the actual increase in gross national product, and the company's market share has remained steady at 14 to 16 percent. Selling prices generally increase in line with cost of manufacturing, and gross margins are not expected to vary from experience over the past five years. Sales are forecasted to increase 11 percent from 19X2 (which is 2 percent above the Department of Commerce Bureau of Economic Analysis estimate of the rise in gross national product in the forecast period), with a market share of 15 percent and unit prices increased to cover forecasted increased cost of manufacturing.

b. *Cost of Sales*

Materials. Materials used by the company are expected to be readily available, and the company has generally used producer associations' estimates of prices in the forecast period to forecast material costs. A significant exception is copper, a major raw material whose market has been disrupted by political events in certain principal producer countries. The company expects to be able to assure sufficient supplies and estimates that the cost of copper will increase by 22 percent over 19X2. However, due to the uncertainties noted above, industry estimates of copper prices in the forecast period range from 15 to 30 percent above 19X2 prices. A variation of five percentage points in the actual increase above or below the assumed increase would affect forecasted net earnings by approximately $485,000.

Labor. The company's labor union contract, which covers substantially all manufacturing personnel, was negotiated in 19X2 for a three-year period. Labor costs are forecasted based upon the terms of that contract.

c. *Plant and Equipment and Depreciation Expense.* Forecasted additions to plant and equipment, $4.4 million, comprise principally the regular periodic replacement of manufacturing plant and vehicles at suppliers' quoted estimated prices and do not involve any significant change in manufacturing capacity or processes. Depreciation is forecasted on an item-by-item basis.

d. *Selling, General, and Administrative Expenses.* The principal types of expense within this category are salaries, transportation costs, and sales promotion. Salaries are forecasted on an individual-by-individual basis, using expected salary rates in the forecast period. Pension cost is planned to be funded and is forecasted based upon its direct relationship to payroll cost. Transportation costs comprise principally the use of contract carriers; volume is forecasted based upon the sales and inventory forecasts (including forecasts by sales outlet), and rates are forecasted to rise by 16 percent over 19X2, based upon trucking industry forecasts. Sales promotion costs are expected to increase in line with the consumer price index (assumed to rise 9 percent based on the mean of [several widely used estimates]) and, except for a special campaign budgeted at $750,000, are expected to remain at a level similar to 19X2. The level of other expenses is expected to remain the same as in 19X2, adjusted for the assumed inflation rate of 9 percent.

e. *Bank Borrowings and Interest Expense.* The forecast assumes that the company will obtain an extension of existing short-term lines of credit at terms comparable to those in effect in 19X2 (2 percent over prime rate). The company used the arithmetic mean of [three widely used estimates] of bank prime rate during the forecast period (ranging from 8 percent to 10 percent) to estimate prime rate at 9 percent. The company forecasted additional long-term borrowings of $6 million and has entered into preliminary negotiations with its bankers for this financing. The borrowings are principally to fund purchases of plant and equipment and additions to other long-term assets and will be secured by such additions. Based upon the preliminary negotiations, the company has assumed that the additional long-term financing will bear interest at 10 percent.

f. *Income Taxes.* The provision for income taxes is computed using the statutory rates in effect during 19X2, which are not expected to change, and assuming investment tax credit on qualifying investments at rates in effect in 19X2.

g. *Dividend.* The company's normal dividend policy is to pay out the previous year's dividend increased to the extent of at least one-third of any increase in profits over the previous year, provided the board of directors considers that the company's cash and working-capital position will not be adversely affected. The dividend has been forecasted at $1.50 per share, assuming an increased payout over 19X2 of one-third of the excess of forecasted net earnings for the year ending December 31, 19X3, above those of 19X2. The board of directors wishes to emphasize that the actual payment of the forecasted dividend is contingent both on the achievement of the forecasted net earnings and on the company's future cash position and, accordingly, is not assured.

Summary of Significant Accounting Policies

The financial forecast has been prepared on the basis of the generally accepted accounting principles expected to be used in the historical financial statements covering the forecast period, which are the same as those used to prepare the historical financial statements for the year ended December 31, 19X2, as described in the Summary of Significant Accounting Policies on page xx.

Appendix A

Management Advisory Services Guideline Series Number 3

Guidelines for Systems for the Preparation of Financial Forecasts

NOTICE TO READERS

Management Advisory Services guidelines are published to assist members in carrying out various types of services. They represent the recommendations of the Management Advisory Services Executive Committee as to the best practices in the areas covered.

Guidelines for Systems for the Preparation of Financial Forecasts

Introduction

Background

Persons concerned with economic matters and especially with economic decisions are usually interested in predictions of the future. Recently great interest has been shown in the possible preparation, by company management, of earnings forecasts which would subsequently be made available to security holders, potential investors, and the public.

SEC Pronouncements

The Securities and Exchange Commission, which historically has prohibited the inclusion of financial forecasts in prospectuses and reports filed with it, has now indicated that it will propose changes in its policies to permit the publication of forecast data under certain conditions.[1] In its statement on this subject, the commission indicated that companies under its jurisdiction should not be required to make forecasts, but that those who choose to do so should be required to meet certain standards and disclosure requirements, including rules for filing with the commission. The commission's statement also indicates that no certification of the

1"Statement by the Commission on the Disclosure of Projections of Future Economic Performance," Securities Act of 1933, SEC Release No. 5362. February 2, 1973.

forecast by any third party would be permitted in filings with the commission. The commission has stated its intention to develop such standards and rules but, as of the publication date of this document, no such proposed standards and rules have been issued.

The commission contemplates that a company subject to its jurisdiction that publicly discloses a forecast should be required to file such forecasts with the commission, to disclose how the forecasts were made and their underlying assumptions, to update the forecast on a regular basis to reflect material changes, and to provide a comparison of the forecast with actual results. A company would be permitted to stop issuing forecasts at its discretion with appropriate disclosure of the reasons for cessation or withdrawal.

Current Status of Financial Forecasts

A few companies have included a financial forecast or elements thereof in their annual reports to stockholders and in other generally available material. Forecast information is frequently made available on an informal basis to creditors, potential credit grantors, security analysts, and selected investors. Financial forecasts have sometimes been included in the offering material of certain bond issues relating to hospitals, airports, public facilities, and so forth.

A very high percentage of large companies and many smaller companies regularly prepare budgets or profit plans for internal management use and many of these companies also prepare financial forecasts for internal use.

In spite of the widespread preparation of financial forecasts, no authoritative statement of guidelines or standards exists for their preparation. Such guidelines are necessary if published forecasts are to be useful to the public. Although the Securities and Exchange Commission has stated its intent to issue forecasting guidelines, it is desirable and is consistent with commission policy that these guidelines be developed in the private sector and be based on experience with financial forecasting.

Objective of This Report

The objective of this document is to define guidelines for a system for the preparation of financial forecasts. The formal presentation of forecasts, including disclosure requirements, and the possible attestation of forecasts are outside the scope of these guidelines.

The publication of financial forecasts is neither advocated nor discouraged. This document has been prepared because financial forecasts are being disseminated, and accordingly, there is a need for authoritative guidelines for their preparation.

Ordinarily, financial forecasts are prepared as the output of a forecasting system that embraces the preparation of a forecast, the subsequent monitoring of actual results relative to the financial forecast, and the updating or revision of forecasts. These guidelines address the requirements such a system should meet.

There may be circumstances in which a financial forecast is prepared without benefit of a formal system—for example, forecasts prepared for a new enterprise or for a very small company. In such situations, a formal work program and an appropriately constituted forecast project team may be utilized in place of a forecasting system and still conform to these guidelines. The work program must provide for adequate definition of the procedures, methods, and practices to be employed.

Definitions and Scope

Common usage in practice has not developed consensus on the definition of such terms as forecast, projection, feasibility study, and budget. To improve the clarity of this document, the following definitions have been adopted and used throughout.

Financial Forecast

A financial forecast for an enterprise is an estimate of the most probable financial position, results of operations, and changes in financial position for one or more future periods.

In this context, *enterprise* means an entity for which financial statements could be prepared in accordance with generally accepted accounting principles.

Most probable means that the assumptions have been evaluated by management and that the forecast is based on management's judgment of the most likely set of conditions and its most likely course of action.

The preparation of a financial forecast will ordinarily involve the forecasting of the entity's financial position and cash flow as well as the financial results of its operations. Certain elements of financial results, such as interest expense, frequently cannot be reliably estimated without forecasting cash flow and financial position.

The period of a financial forecast will depend on many factors such as the nature of the forecast's intended use, the economic situation, and the nature of the industry, and thus can be expected to differ by company. In forecasting and particularly in updating a forecast, part of the forecast period may have already expired, so that the financial forecast may consist of elements of attained results as well as estimates of the future.

Financial Projections

In contrast, a *financial projection* for an enterprise is an estimate of financial results based on assumptions that are not necessarily the most likely. Financial projections are often developed as a response to such questions as "What would happen if . . . ?" While many of the same principles apply, these guidelines are not directed toward the preparation of financial projections.

Feasibility Study

A *feasibility study* is an analysis of a proposed investment or course of action. A feasibility study frequently involves the preparation of financial projections and, under certain circumstances, may involve the preparation of a financial forecast. A financial forecast may in turn be based on the results of a feasibility study used in the formulation of management's plans.

These guidelines are not directed toward the preparation or conduct of financial feasibility studies; however, the guidelines are applicable to the preparation of financial forecasts contained within a feasibility study.

Financial Forecasting Systems

A system consists of a set of policies, procedures, methods, and practices systematically applied by qualified personnel. It embraces inputs, processing, and outputs of the system and includes the collection, recording, analysis, interpretation, processing, and review of information concerning all elements of the enterprise that are significantly interrelated relative to a particular area.

A financial forecasting system consists of a set of related policies, procedures, methods, and practices that are used to prepare financial forecasts, monitor attained results relative to the forecast, and prepare revisions or otherwise update the forecast. The system may or may not employ mechanized data-processing techniques.

Budgets, Plans, Goals and Objectives

Budgets, plans, goals, and objectives also involve elements of predicting the future. However, each of these tends to have elements distinguishing it from a financial forecast, although in some situations, each may be identical to a forecast. Budgets, plans, goals and objectives may have some elements of being targets or motivational hurdles. Budgets, especially, involve motivational, control, and performance evaluation considerations. A financial forecast should recognize these factors, but the forecast should be an objective, logical, supported statement of the most probable financial results.

Under appropriate circumstances, a planning or budgeting system may provide the basis for developing a forecast. These guidelines are applicable whether the financial forecast is prepared by a separate forecasting system or through the use of related planning and budgeting systems.

Nature of Forecasting

Forecasts are derived through a combination of judgment and science in which history, plans, reactions, aspirations, constraints, and pressures all play a part. Forecasts are based on management's assumptions of future events, some of which assumptions are explicit, but many of which are implicit. The assumptions, in turn, are based on present circumstances and information currently available, including both internal and external data. Forecasts may be affected favorably or unfavorably by many factors such as revenues, costs, employee relations, taxes, governmental controls, and general economic conditions. Accordingly, there is no assurance that the forecasted results will be achieved.

No one can know the future. Predictions are based on information about the past and present. Of necessity, judgment must be applied to estimate when and how conditions are likely to change. These judgments may subsequently prove to be inaccurate; thus, the accuracy and reliability of a forecast can never be guaranteed. Forecasts by their very nature are subject to error. When a succession of forecasts is made over a period of time, it is inevitable that at some point a particular forecast will turn out to have been significantly inaccurate. Because of this, forecasts may require updating and revision when conditions significantly change.

Forecast information is substantially less subject to objective verification than historical data. Expected results are often not achieved because of unforeseen occurrences. When working with or using forecast information, it is essential to understand the inherent exposure to inaccuracy involved in any forecast.

The difficulty in making a financial forecast can vary significantly from enterprise to enterprise, from industry to industry, and from time to time. Also, a financial forecast can be especially difficult to prepare in the case of a new venture, where no historical record of performance exists upon which to base a forecast.

Approach and Applicability of the Guidelines

This document establishes the broad principles and requirements which should govern the preparation of financial forecasts. These guidelines should have wide applicability to many kinds of enterprises; however, judgment is required to apply and interpret these guidelines to specific situations.

Many different forecasting techniques and methods are available. The relevance of a particular technique for forecasting for a given enterprise at a given point in time must be determined largely on a case-by-case basis, depending on the specifics of the individual situation. Consequently, these guidelines do not address themselves to individual forecasting techniques.

In approaching guidelines for a system for the preparation of financial forecasts, some might look to very specific prescriptions as to how specific items should or should not be forecast. Examples would be standards for overall sales forecasting or perhaps for forecasting sales within a specific industry. However, financial forecasting is applicable to such a wide range of enterprises and the economy is so diverse and dynamic that the development of guidelines on such a specific basis is not practicable at this time.

These guidelines for systems for the preparation of financial forecasts are intended to apply to enterprises that prepare financial forecasts on a recurring basis and where updating may be necessary. These guidelines also apply to the preparation of forecasts that are not recurrent or where a formal forecasting system does not exist but where a formal work program and an appropriately constituted forecasting project team are used.

Role of the CPA

The preparation of a financial forecast is the responsibility of the management of an enterprise. Management may require the assistance and counsel of outside professionals in meeting this responsibility. Nothing in this document precludes the CPA from assisting management in the preparation of financial forecasts and in the development of forecasting systems.

Summary of Guidelines

1. *Single most probable result.* A financial forecasting system should provide a means for management to determine what it considers to be the single most probable forecasted result. In addition, determination of the single most probable result generally should be supplemented by the development of ranges or probabilistic statements.

2. *Accounting principles used.* The financial forecasting system should provide management with the means to prepare financial forecasts using the accounting principles that are expected to be used when the events and transactions envisioned in the forecast occur.

3. *Appropriate care and qualified personnel.* Financial forecasts should be prepared with appropriate care by qualified personnel.

4. *Best information available.* A financial forecasting system should provide for seeking out the best information, from whatever source, reasonably available at the time.

5. *Reflection of plans.* The information used in preparing a financial forecast should reflect the plans of the enterprise.

6. *Reasonable assumptions suitably supported.* The assumptions utilized in preparing a financial forecast should be reasonable and appropriate and should be suitably supported.

7. *Relative effect of variations.* The financial forecasting system should provide the means to determine the relative effect of variations in the major underlying assumptions.

8. *Adequate documentation.* A financial forecasting system should provide adequate documentation of both the forecast and the forecasting process.

9. *Regular comparison with attained results.* A financial forecasting system should include the regular comparison of the forecast with attained results.

10. *Adequate review and approval.* The preparation of a financial forecast should include adequate review and approval by management at the appropriate levels.

Guideline No. 1

A financial forecasting system should provide a means for management to determine what it considers to be the single most probable forecasted result. In addition, determination of the single most probable result generally should be supplemented by the development of ranges or probabilistic statements.

Users of forecasts have need in many circumstances for a single estimate representing the most probable financial result. The need for a single forecast is particularly great for users external to the enterprise. In addition, the comparison of a forecast with actual attained results is facilitated when the single most probable forecast is available.

The management of a company, through the use of its forecasting system, is in the best position to determine the single most probable forecasted financial result; consequently, a financial forecasting system should provide management with the means to determine it.

Because forecasts are not exact and are subject to varying degrees of inaccuracy, preparing a forecast in a manner that conveys the degree of uncertainty associated with it is very useful and should be encouraged. This guideline is intended to encourage the development of ranges, probabilistic statements, or estimates of error as supplements to the single most probable forecasted result. Such information is useful to underscore the essentially uncertain nature of all forecasts.

Guideline No. 2

The financial forecasting system should provide management with the means to prepare financial forecasts using the accounting principles that are expected to be used when the events and transactions envisioned in the forecast occur.

The objective of a financial forecast is to estimate financial results as they will be recorded in the financial statements of the enterprise once the events have occurred. Therefore, the accounting treatment applied to anticipated events and transactions in a forecast should be the same as the accounting treatment expected to be applied in recording the events once they have occurred.

From time to time organizations change the accounting principles they use. If such changes are expected, they should be reflected in the forecast and documented. The meaningfulness of financial data is enhanced when it is comparable to the data for other time periods. Therefore, when such changes in accounting treatment are anticipated, the forecasting system should include a means to adjust the financial data to a comparable basis.

Guideline No. 3

Financial forecasts should be prepared with appropriate care by qualified personnel.

Appropriate care requires that diligence and proper attention be exercised to ensure that the forecast is as reliable as is reasonable under the circumstances. The forecast should be honestly and objectively prepared in good faith with neither undue optimism nor pessimism. The preparer should question the validity of all information and assumptions.

The preparation of a financial forecast ordinarily involves the use of large amounts of data and requires a great many calculations, a situation which introduces the possibility of clerical error. Procedures should be utilized to facilitate the detection, control, and elimination of such errors.

Qualified personnel are necessary to ensure that appropriate knowledge and competence are present or acquired during the course of the forecasting work. An understanding of the enterprise and industry is essential. Personnel having competence in marketing, operations, finance, research and engineering, and other technical areas as appropriate should participate along with management in the development of the forecast.

Analytical capacity and expertise in the analysis and interpretation of the relevant historical data are also necessary. In appropriate circumstances, expertise in technical forecasting techniques and methodology is required.

Guideline No. 4

A financial forecasting system should provide for seeking out the best information, from whatever source, reasonably available at the time.

Information relevant to a forecast comes from many sources, both within and outside an organization. An effective forecasting system should provide for searching out information relevant to a forecast to achieve the best, most reliable information reasonably available.

The acquisition of information ordinarily involves a cost. This cost should be commensurate with the anticipated benefits to be derived from the information. For example, the cost of making a survey may far exceed any potential benefit, even though the survey might provide the most precise information available. This guideline does not require the acquisition of information regardless of cost, although it does not eliminate the requirement merely because it may be costly.

A forecast can only be based on information available at the time it is prepared. Often information permitting a more accurate forecast becomes available only after a forecast has been completed or disclosed or after the forecast period has expired. The fact that information exists does not necessarily mean that it is available to the forecasters.

Various sources of information involve different degrees of reliability. The reliability of the basic data should be considered in the forecasting process.

A key consideration in the preparation of a financial forecast is the use of an appropriate level of detail. In certain situations the use of more detail may improve the reliability of a forecast. For example, forecasting sales by product line instead of in the aggregate may improve the sales forecast, especially when the products are sold in different markets. However, situations also exist where the use of less detail or a more aggregated approach will improve reliability. For example, forecasting the cost of sales for a manufacturer of thousands of individual items may be done more effectively in groups than by individual item.

Guideline No. 5

The information used in preparing a financial forecast should reflect the plans of the enterprise.

A financial forecast should reflect the expected economic effects of anticipated management strategies, programs, and actions, including those being planned in response to the assumed future conditions.

Management's plans expressed in the form of budgets, goals, policies, and plans are a necessary part of the information going into a forecast. Care must be exercised to eliminate the effect of undue optimism or pessimism contained in such plans.

Plans and budgets are more reliable and credible when developed through the use of effective management planning and control systems. Sound reporting on a timely basis by functional responsibility, together with effective planning and budgeting, is the foundation of a financial forecasting system.

Guideline No. 6

The assumptions utilized in preparing a financial forecast should be reasonable and appropriate and be suitably supported.

Assumptions are the essence of forecasting and are the single most important ingredient of a financial forecast. The quality of the underlying assumptions largely determines the reliability of a forecast.

Assumptions vary in their relative potential importance to forecasted results. The attention devoted to the appropriateness of a particular assumption should be commensurate with the likely relative impact of that assumption. Assumptions with great impact should receive more attention and support than those with less impact. Often, assumptions pertaining to sales volumes and revenues have the greatest single impact on the financial forecast for an enterprise.

By nature, a financial forecast always contains a large number of assumptions, some of which may be obvious and explicit but many of which are implicit and obscure. Frequently, the most basic assumptions with enormous potential impact, such as those relating to war or peace conditions, are not addressed explicitly in the preparation of a forecast. However, those assumptions deemed to be most significant at the time of preparation should be made explicit to focus attention on them and to facilitate review by management.

Assumptions should be supported by appropriate evidence. While it is not possible to absolutely prove that any given assumption will be borne out by subsequent events, much evidence consisting of data and logical argument or theory is usually developed to support an assumption. Historical data appropriately analyzed will often reveal trends or other likely patterns of behavior. Special scrutiny should be given assumptions that are not consistent with past and current conditions.

Although it is ordinarily not feasible to exhaustively list and otherwise document and support all the assumptions underlying a forecast, nevertheless it is necessary to seek out and explicitly state support for the most crucial or significant assumptions. Despite these precautions, hindsight will often reveal basic assumptions that have been overlooked or that, in the light of later circumstances, received inadequate treatment. Furthermore, the nature of forecasting is such that some assumptions will turn out to be erroneous no matter what effort, analysis, or support may be applied.

In analyzing alternative assumptions, care must be exercised to avoid undue optimism or pessimism and to assess the situation objectively. Relating an assumption to past or present conditions often is a useful approach to check on reasonableness; however, trends are not necessarily reliable indicators of the future. Particular attention should be given to the possibility of changes in conditions and these must rest mainly on theory and an understanding of the basic causal factors.

Care should be exercised to avoid unrealistic assumptions in situations where any assumption may involve a certain degree of arbitrariness. For example, it may be difficult to predict the precise rate of future cost inflation, but it is generally more realistic to estimate such a rate than to assume no inflation. Often, the most difficult assumptions to evaluate are those relating to worldwide macroeconomic conditions. In such cases, management is placed in the position of using subjective judgment to a greater degree than in many other cases.

The nature of business enterprise is such that many underlying assumptions are interrelated and certain of their elements may have multiple impacts. For example, a slowdown in economic activity will typically not only result in a slowdown in sales volume, but may also affect prices and the availability and cost of resources.

The conditions assumed in arriving at the sales or revenue forecast should be consistent with those assumed in forecasting the cost of operations. Care should be exercised to insure that likely costs and revenues have been considered, that sufficient capacity and resources will be available to produce the expected revenues, that capital expenditures have been recognized as appropriate, that provision has been made for applicable taxes, and that appropriate financing has been considered.

Guideline No. 7

The financial forecasting system should provide the means to determine the relative effect of variations in the major underlying assumptions.

Forecasted financial results are usually relatively more sensitive to certain elements and less responsive to others. Small changes in certain assumed conditions can result in relatively large variations in the predicted results, while relatively large changes in other elements cause only minor shifts in the forecasted result.

In forecasting, an understanding of the relative sensitivity of the results to the assumed conditions permits the allocation of analysis, study, and review to those areas with the most significant impact. Particular attention should be devoted to those items likely to cause large variations in the results.

Knowledge of a particular enterprise or industry frequently permits an initial identification of those key factors upon which the financial success of the business rests. In the absence of such knowledge, additional analysis should be performed to identify the most sensitive elements.

Guideline No. 8

A financial forecasting system should provide adequate documentation of both the forecast and the forecasting process.

Documentation makes possible management review and approval of a forecast. It facilitates comparison of the forecast with actual financial results, and it provides the discipline necessary for reliable forecasting.

Documentation involves recording the underlying assumptions as well as summarizing the supporting evidence for the assumptions. Documentation should provide the ability to trace forecasted financial results through intermediate calculations back to the basic underlying assumptions.

Adequate documentation makes it possible for persons experienced and qualified in forecasting to reconstruct the forecast. Documentation should cover the system, as well as individual forecasts, and should provide an organized record of both that can be maintained and made available for subsequent use.

Guideline No. 9

A financial forecasting system should include the regular comparison of the forecast with attained results.

The objective of a forecast is to estimate financial results for one or more future periods. The regular comparison of forecasted results with actual results provides a historical measure of forecasting success and may also be useful as an indication of the likely reliability of future forecasts. Regular comparison with actual results and analysis of deviations also provide a basis for making improvements in the forecasting methods and approaches.

The comparison with actual results should not be limited to financial results but should also include comparison of the underlying factors and key assumptions, such as sales volumes, prices, and production rates. Emphasis should be placed on those items sometimes called leading indicators, such as order rates, backlogs, and changes in capacity that precede attained financial results but that largely determine future results.

Comparison of the forecast with actual results should occur on a regular basis throughout the period of the forecast. Deviations from the forecast should be analyzed to provide an early indication that the forecast may be inaccurate and may need to be supplanted by the preparation of an updated or revised forecast. However, when recurring forecasts are not prepared, comparison on a regular basis throughout the period of the forecast may not be necessary.

Guideline No. 10

The preparation of a financial forecast should include adequate review and approval by management at the appropriate levels.

A financial forecast is an important statement of the most probable future financial results of an enterprise. The ultimate responsibility for a forecast rests with management at the highest responsible level of authority, the same level as for historical financial statements. Thus, this responsibility rests with the officers and directors of the company.

Adequate review means that the review is conducted in sufficient depth to assure the reviewers of the soundness of the forecasting process. The reviewer should satisfy himself that the forecast and subsequent revisions were prepared in accordance with the guidelines for the preparation of forecasts. Adequate review and approval require formal communication of the forecast, together with its supporting documentation.

Review at intermediate levels of management—including such functions as marketing, operations, engineering, and finance—insures that the reasonableness of the forecast is evaluated from several vantage points and especially that it is evaluated by those who will be responsible for the subsequent delivery of forecasted results.

Appendix B

Statement of Position 75-4

Presentation and Disclosure of Financial Forecasts

August 1975

Issued by the
Accounting Standards Division of the
American Institute of Certified Public Accountants

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. This Statement represents the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting, cost accounting, and financial forecast presentation. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

The objective of this Statement of Position is to provide general information and guidance to members and others on the *Presentation and Disclosure of Financial Forecasts.*

Introduction

This Statement of Position on *Presentation and Disclosure of Financial Forecasts* has been issued by the Accounting Standards Division of the American Institute of Certified Public Accountants because greater interest is being shown in financial forecasts and projections[1] and they increasingly are being disseminated.

Few companies publish forecasts or projections for general dissemination at present. Many companies, however, issue forecasts or projections to lenders, underwriters and prospective investors in connection with obtaining debt or equity financing. They are included in offering circulars for bond issues to finance the construction of hospitals, airports, sports arenas and other public facilities, as well as in offering circulars for limited partnership interests, particularly in real estate.

The Securities and Exchange Commission has historically prohibited the inclusion of forecasts or projections in prospectuses and reports filed with it. However, the Commission has proposed changes in that policy to permit companies to include certain statements regarding future operations in filings made pursuant to the Securities Act and the Exchange Act.[2]

Other Divisions within the AICPA are concerned with related aspects of financial forecasts:

a. *Guidelines for Systems for the Preparation of Financial Forecasts* have been issued by the Management Advisory Services Division (MAS Guideline Series Number 3, March 1975). The guidelines provide direction to the developers of forecasting systems and to the preparers of financial forecasts.

b. The Auditing Standards Division is studying matters relating to a CPA's involvement with his client's financial forecasts and the appropriate reporting by a CPA on such forecasts.

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[1]See *Definitions,* page 2.

[2]Securities Act Release No. 5581, April 28, 1975.

Definitions

Common usage in practice has not developed complete agreement on the definition of certain terms such as *forecast, projection, feasibility study,* and *budget.* For purposes of this Statement of Position, certain definitions have been adopted and used throughout.

Financial Forecast

A financial forecast for an enterprise is an estimate of the most probable financial position, results of operations and changes in financial position for one or more future periods.

In this context —

a. "Enterprise" means an entity for which financial statements could be prepared in accordance with generally accepted accounting principles.

b. "Most probable" means that the assumptions have been evaluated by management and that the forecast is based on management's judgment of the most likely set of conditions and its most likely course of action.

Financial Projection

A financial projection for an enterprise is an estimate of financial results based on assumptions which are not necessarily the most likely. Financial projections are often developed as a response to such questions as "What would happen if?".

Feasibility Study

A feasibility study is an analysis of a proposed investment or course of action. A feasibility study may involve the preparation of financial projections and/or a financial forecast. A financial forecast may in turn be based on the results of a feasibility study used in the formulation of management's plans.

Budgets, Plans, Goals, and Objectives

Budgets, plans, goals, and objectives also involve elements of predicting the future. However, each tends to have elements which distinguish it from a financial forecast although, in some situations, each may be identical to a forecast. Budgets, plans, goals, and objectives may have some of the elements of targets or motivational hurdles. Budgets especially involve motivational, control, and performance evaluation considerations.

Scope of Statement

This Statement provides guidance as to presentation and disclosure for those who choose to issue information about the future described as *financial forecasts*. Nothing herein should be interpreted to mean that the publication of financial forecasts is recommended or that a financial forecast is deemed to be a part of the basic financial statements.

Financial projections, feasibility studies, budgets, plans, goals, and objectives are generally prepared for special purposes and do not fall within the scope of this Statement of Position; financial forecasts contained within a feasibility study do.

Recommendations as to presentation and disclosure of cash flow or tax basis forecasts also do not fall within the scope of this Statement of Position.

Recommendations on Presentation and Disclosure

Format

Financial forecasts preferably should be presented in the format of the historical financial statements[3] expected to be issued, but, at a minimum, the presentation should consist of certain specific information (see below) obtained from such a financial forecast.

Financial forecasts presented in the format of the historical financial statements expected to be issued would facilitate comparisons with results experienced in prior periods and with results actually achieved in the forecast period(s). However, given the lack of experience of most enterprises in issuing financial forecasts, there is reason to consider, for the present, recommendations which would not unduly discourage the issuance of financial forecasts and which would permit experimentation in the development of communicative formats. Accordingly, when information described as a financial forecast is issued, it should include presentation of at least the following information (when applicable):

a. Sales or gross revenues.

b. Gross profit.

[3] The details of each statement may be summarized or condensed, so that only the major items in each are presented. The usual footnotes associated with historical financial statements need not be included as such. However, see *Assumptions*, page 5, for additional comments.

c. Provision for income taxes.

d. Net income.

e. Disposal of a segment of a business and extraordinary, unusual or infrequently occurring items.

f. Primary and fully diluted earnings per share data for each period presented.

g. Significant anticipated changes in financial position.

Accounting Principles

Financial forecasts should be prepared on a basis consistent with the generally accepted accounting principles expected to be used in the historical financial statements covering the forecast period. This fact, as well as a summary of significant accounting policies, should be disclosed in the forecast. If a forecast is included in a document which contains such a summary, disclosure can be accomplished by cross-referencing.

If the financial forecast gives effect to a change in accounting principle from one used in the historical financial statements of prior periods, the change should be reported in the forecast for the period in which it is expected to be made as would be required in reporting such accounting change in historical financial statements.

Expressing the Results

Financial forecasts should be expressed in specific monetary amounts representing the single most probable forecasted result. The tentative nature of a financial forecast would be emphasized if the single most probable result for key measures (e.g., sales and net income) was supplemented by ranges or probabilistic statements, and the presentation of such information is encouraged.

While a range informs the user of the probabilistic nature of the forecast, expressing a financial forecast *solely* in terms of ranges could result in the user's attributing an unwarranted degree of reliability to the forecast ranges, because many users might assume (a) that a range represented the spread between the best possible result and the worst possible result or (b) that the range was based on a scientifically determined interval. Management should be in the best position to determine the single most probable result, and this burden should not be placed on outsiders. Also, single point estimates are necessary to aggregate the forecasts of an enterprise's individual operations, as well as to facilitate comparison between the forecast and later historical results.

Assumptions

Those assumptions should be disclosed which management thinks are most significant to the forecast or are key factors upon which the financial results of the enterprise depend. There ordinarily should be some indication of the basis or rationale for these assumptions. It would also be desirable for the disclosure to include an expression of the relative impact of a variation in the assumption when it would significantly affect the forecasted result.

Frequently, basic assumptions that have enormous potential impact are considered to be implicit in the forecast. Examples might be conditions of peace, absence of natural disasters, etc. Such assumptions need be disclosed only when there is a reasonable possibility that the current conditions will not prevail. In such circumstances, to the extent practicable, the possible impact of a change in the assumptions should be disclosed.

A financial forecast is based on assumptions representing management's judgment of the most likely circumstances and events and its most likely course of action. Assumptions are the single most important ingredient of a financial forecast. However, regardless of the amount of study or analysis, some assumptions inevitably will not materialize.

There are several other factors with respect to the disclosure of assumptions which must be considered, particularly when the disclosures are external to the enterprise.

a. By nature, a financial forecast embodies a large number of assumptions, especially for a complex enterprise. An attempt to communicate "all" assumptions is inherently not feasible.

b. Outside users who disagree with one or more assumptions in a forecast are generally not able to adjust for the effect of these differences in assumptions on the forecast.

c. Questions may arise after the fact as to certain assumptions which were not disclosed. Unforeseen changes in conditions may make certain assumptions, previously considered unimportant, significant.

Consideration of these factors does not change the previous conclusion that significant assumptions underlying a financial forecast should be disclosed.

Disclosure of certain important information may not be desirable from the standpoint of the enterprise, particularly when competition or strategies are involved. While all significant assumptions should be disclosed, they need not be presented in such a manner or in such detail as would adversely affect the competitive position of the enterprise.

Assumptions should be captioned in a manner which best reflects their nature, such as "Summary of Significant Forecast Assumptions." It should be made clear that the assumptions disclosed are not an all-inclusive list of those used in the preparation of the forecast and that they were based on circumstances and conditions existing at the time the forecast was prepared. Accordingly, the summary of assumptions should be preceded by an introduction similar to the following:

> This financial forecast is based on management's assumptions concerning future events and circumstances. The assumptions disclosed herein are those which management believes are significant to the forecast or are key factors upon which the financial results of the enterprise depend. Some assumptions inevitably will not materialize and unanticipated events and circumstances may occur subsequent to ____________________, the date of this forecast. Therefore, the actual results achieved during the forecast period will vary from the forecast and the variations may be material.

Identifying those assumptions which, at the time of preparation, appear to be most significant to the forecast or which are key factors upon which the financial results of the business depend requires the careful exercise of good-faith judgment by management. The disclosures should include the following:

a. Assumptions as to which there is a reasonable possibility of the occurrence of a variation that may significantly affect the forecasted results.

b. Assumptions about anticipated conditions that are expected to be significantly different from current conditions, which are not otherwise reasonably apparent.

c. Other matters deemed important to the forecast or to the interpretation of the forecast.

The following unrelated hypothetical examples of disclosures of assumptions are offered for general guidance:

a. The Company is engaged in several lines of business, two of which are defense-oriented and supplied X% and Y% of the Company's sales and gross profit, respectively, in 1974, as indicated on page___of the Annual Report to Stockholders. The Company's other lines of business are diversified.

The sales forecast assumes, among other things, that revenue from the Company's federal defense contracts will continue at the current level and that non-defense sales will increase at the same rate as the anticipated increase in real GNP for 1975.

If these conditions are not met, results may be significantly affected. For example, a decline of 5% from forecasted defense-oriented sales could result in a decline of approximately 8% in net income, while a decline of 5% from forecasted non-defense sales could result in a decline of approximately 6% in net income.

b. The Company expects its raw material costs to rise, on an overall basis, commensurate with the rate of inflation. The forecast assumes any raw material cost increases can be recovered in the form of higher prices.

   Labor costs have been forecast using rates provided in the Company's union contract, which does not expire until 1976.

c. At certain times in the year, the Company is highly dependent on short-term bank borrowing. The Company's forecast of interest expense is based on the seasonal borrowing patterns of prior years for financing inventory and receivables. The Company does not expect to incur any long-term borrowing and anticipates no major changes in the prime rate from its present level of X%.

d. The provision for income taxes gives no effect to the possibility of a 6% decrease in the maximum corporate income tax rate, as proposed by the President in a message to Congress.

e. Manufacture of the Company's major products depends on the availability of relatively small quantities of petroleum by-products. The Company has no guaranteed source for these materials. The forecast assumes continued availability of these raw materials.

f. Earnings per share data have been computed following the same procedures used for historical financial statement purposes, which are in accordance with the provisions of APB Opinion No. 15. In calculations required by the "treasury stock" method, management has assumed, for such purposes, that there will be no significant changes in the price of the Company's stock.

Period to be Covered

Management should consider its ability to forecast and the needs of the user in determining the period to be covered. No fixed period of time is specified herein.

Although the degree of uncertainty generally increases with the time span, short-term forecasts may not be meaningful in (a) industries with a lengthy operating cycle or (b) situations where long-term results are necessary to evaluate the investment consequences involved.

Distinguishing From Historical Financial Statements

Financial forecasts should be presented separately (or clearly segregated) from the historical financial statements and should be clearly labeled as a "financial forecast" to preclude a reader from confusing a forecast with the historical financial statements.

Applicable historical *information,* such as prior forecast data and prior historical results, may, however, be presented with any financial forecast in parallel columns. This would facilitate comparison and provide the user with information helpful in evaluating the risks associated with a financial forecast. When such historical information is presented, it should be clearly labeled and distinguished from the forecast information.

Updating Financial Forecasts

An updated financial forecast should be issued to reflect significant changes in assumptions, actual results, or unanticipated events and circumstances unless (a) the original forecast included a statement that it was not intended to be updated (see page 9) or (b) issuance of historical financial statements covering the forecast period is imminent.

An updated forecast should be issued if it can be done promptly. The reasons for updating should be described in a note to the updated forecast.

When material changes in a forecast cannot be quantified so as to permit issuance of an updated forecast promptly, appropriate disclosure should be made. Such disclosure would include a description of the circumstances necessitating an updated forecast, and notification that the forecast should not be used for any purpose and that an updated financial forecast will be issued upon its completion.

If, however, management decides that the current financial forecast should no longer be used for any purpose but it is not appropriate to issue an updated forecast, this decision and the reasons for it should be disclosed.

Forecasts Not Intended to be Updated

Financial forecasts may be issued on a "one-time" basis, such as in connection with a search for debt or equity financing, without any intention to issue updated forecasts. In such cases, emphasis should be given to the date of issuance of the forecast and an explicit statement should be made as to the dangers inherent in using forecasts issued some time ago. In addition, management's intention not to update the forecast should be specifically disclosed.

Appendix C

Securities and Exchange Commission's Releases

Guides for Disclosure of Projections of Future Economic Performance (November 7, 1978)

Safe Harbor Rule for Projections (June 25, 1979)

SECURITIES ACT OF 1933

SECURITIES ACT OF 1933
Release No. 5992/November 7, 1978

SECURITIES EXCHANGE ACT OF 1934
Release No. 15305/November 7, 1978

Guides for Disclosure of Projections of Future Economic Performance

AGENCY: Securities and Exchange Commission.

ACTION: Publication of revised guides.

SUMMARY: The Commission is issuing a statement encouraging the disclosure of projections and has authorized publication of Guides 62 and 5 of the Guides for Preparation and Filing of Registration Statements under the Securities Act of 1933 and of the Guides for the Preparation and Filing of Reports and Proxy and Registration Statements under the Securities Exchange Act of 1934, respectively. The Guides relate to the voluntary public disclosure by an issuer of projections of its future economic performance, both with respect to documents filed pursuant to the requirements of the federal securities laws and otherwise. The Guides set forth the Division of Corporation Finance's views regarding significant considerations to be taken into account in the disclosure of projections. In a related action, to further encourage the voluntary disclosure of projections by public companies the Commission is proposing for comment a rule to the effect that registrants generally would not be held liable under the federal securities laws for reasonably based projections made in good faith that are subsequently proven erroneous. See Release No. 33-5993 under Proposed Rules in this issue.

EFFECTIVE DATE: The Guides will be followed by the Commission upon publication in the *Federal Register*.

FOR FURTHER INFORMATION CONTACT: Steven J. Paggioli, Office of Disclosure Policy and Proceedings, Division of Corporation Finance, Securities and Exchange Commission, Washington, D.C. 202-376-8090.

SUPPLEMENTARY INFORMATION: The Commission has issued a statement indicating that it encourages certain issuers of securities to publish projected financial information in filings with the Commission or otherwise. The Commission also has authorized publication of Guides 62 and 5, "Disclosure of Projections of Future Economic Performance," of the Guides for the Preparation and Filing of Registration Statements under the Securities Act of 1933[1] (the "Securities Act") (15 U.S.C. 77a et seq.) and the Guides for the Preparation and Filing of Reports and Proxy and Registration Statements under the Securities Exchange Act of 1934 (the "Exchange Act") (15 U.S.C. 78a et seq.). The Guides are not Commission rules nor do they bear the Commission's official approval; they represent practices followed by the Division of Corporation Finance in administering the disclosure requirements of the Securities Act and the Exchange Act.

In Securities Act Release No. 33-5699, April 23, 1976, 41 FR 19986, the Commission expressed its general views on the inclusion of projections in Commission filings and authorized the publication for public comment of then proposed Guides 62 and 4.[2]

Although the Guides were published for comment in Release 5699, the Commission indicated that the Division of Corporation Finance would follow the guides pending final action. The discussion which follows addresses certain issues raised in Release No. 33-5699 and the comments received thereon. However, attention is directed to the text of the Guides for a more complete understanding.

Background and Purpose

The issue of projections, economic forecasts, and other forward-looking information has been under active consideration by the Commission for several years.[3]

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1. Securities Act Release No. 4936, December 9, 1968 (33 FR 18617) as amended, 17 CFR 231.4936, as amended.

2. While proposed Guides 62 and 4 as announced in Release 33-5699 were pending, the Commission adopted new Guide 4, "Integrated Reports to Shareholders," on June 17, 1977, Securities Exchange Act Release 3639, 42 FR 31780 (June 23, 1977). Accordingly, the amended Guide under the Exchange Act is published today as Guide 5.

3. The Accounting Standards Division of the American Institute of Certified Public Accountants published a statement of position on "Presentation and Disclosure of Financial Forecasts" in August, 1975. The definitions of "financial forecast" and "financial projection" set forth there distinguish between a projection, which relates to "financial results based on assumptions which are not necessarily the most likely," and a forecast, which focuses on "the most probable financial position, results of operations and changes in financial position . . ." Although the semantic distinctions may become conformed over a period of time, the Commission emphasizes that in addressing the area of projections it envisions a concept which encompasses both forecasts and projections, as those terms were used by the AICPA. Thus, any statement by the issuer concerning future financial performance could be viewed as a projection subject to the guideline published herein, including those portions of the guide which require that the issuer have a reasonable basis for issuing such data; that the format and content of the projection not be susceptible of misleading inferences; and that the projection be presented in such a manner as will promote investor understanding.

Also, see Report of the Advisory Committee on Corporate Disclosure to the SEC

On November 1, 1972, the Commission announced a public rule-making proceeding relating to the use, both in Commission filings and otherwise, of projections by issuers whose securities are publicly traded.[4] These hearings were ordered by the Commission for the purpose of gathering information relevant to a reassessment of its policies relating to disclosure of projected sales and earnings.

Information gathered at the hearings, held from November 10 to December 12, 1972, reinforced the Commission's observation that management's assessment of a company's future performance is of importance to investors, that such assessment should be comprehensible in light of the assumptions made and should be available, if at all, on an equitable basis to all investors. The hearings also revealed widespread dissatisfaction with the absence of guidelines or standards that issuers, financial analysts, or investors can rely on in issuing or interpreting projections.

On February 2, 1973, the Commission released a "Statement by the Commission on the Disclosure of Projections of Future Economic Performance."[5] In this statement, the Commission determined that on the basis of the information obtained through the hearings, staff recommendations, and its experience in administering the federal securities laws, changes in its long standing policy generally not to permit the inclusion of projections in registration statements and reports filed with the Commission would assist in the protection of investors and would be in the public interest. The Commission also set forth several conclusions regarding the manner in which projections should be made and announced that it had directed the Division of Corporation Finance to prepare specific releases and rule and form changes to implement the Commission's plan to integrate projections into the disclosure system.

On April 25, 1975 the Commission published a series of rule and form proposals relating to projections of future economic performance.[6] These proposals would have established an elaborate disclosure system for companies choosing to make public projections.

Approximately 420 letters of comment were received on these proposals. Although the majority of commentators agreed that projection

(hereinafter "Report"), House Committee on Interstate and Foreign Commerce, 95th Cong., 1st Sess., Committee Print 95-29 (2 vols.), November 3, 1977, Appendix X-A for a general discussion of the development of the Commission's practices relating to projections, at A-265.

4. Securities Exchange Act Release No. 9844 (November 1, 1972) 37 FR 23850.

5. Securities Act Release No. 5362 (February 2, 1973) 38 FR 7220.

6. Securities Act Release No. 5581 (April 25, 1975) 40 FR 20316. These proposals also dealt with more timely reporting of changes in control of a registrant on Form 8-K. Amendments to the change in control disclosure requirement of Form 8-K were adopted in Securities Exchange Act Release No. 13156, January 13, 1977, 42 FR 4424.

information is significant, virtually all of them opposed the proposed system because they felt that the proposals would inhibit rather than foster projection communications between management and the investment community.[7] Due to the important legal, disclosure policy, and technical issues raised by the commentators, the Commission on April 23, 1976, determined to withdraw all but one of the proposed rule and form changes regarding projections.[8]

The Commission did, however, express its general views in the April 1976 release on the inclusion of projections in Commission filings, and authorized the publication for comment of proposed guides for the disclosure of projections in Securities Act registration statements and Exchange Act reports.

Release 33-5699 and the Proposed Guides

In its statement of general views in Release 33-5699, the Commission indicated that it would not object to disolosure in filings with the Commission of projections which are made in good faith and have a reasonable basis, provided that they are presented in an appropriate format and accompanied by information adequate for investors to make their own judgments. The Commission also expressed its concern over the problem of selective disclosure of material non-public information regarding registrants and reminded issuers of their responsibilities under the federal securities laws in connection with the dissemination of management's assessment of a company's future performance. The Commission noted that registrant's responsibilities to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition may extend to situations where management knows its previously disclosed assessments no longer have a reasonable basis.

Advisory Committee Recommendations

The Commission's disclosure policy on projections and other items of soft information was among the subjects considered by the Advisory Committee on Corporate Disclosure. In its final report, issued November 3, 1977, the Advisory Committee made several recommendations for significant changes in that policy.[9] Generally, the Committee

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7. See "Evaluation of SEC Policies and Practices Regarding Projections," in *Report supra* note 3, at A-265.

8. Securities Act Release No. 5699 (April 23, 1976) 41 FR 19986. The adopted amendment deleted the phrase "predictions as to specific future earnings" from the items of information described in note (c) to Rule 14a-9 under the Exchange Act (17 CFR 240.14a-9) as being possibly misleading.

9. *Report, supra* note 3, at 344-79.

recommended that the Commission issue a public statement encouraging companies voluntarily to disclose management projections in their filings with the Commission and elsewhere. In making this recommendation, the Advisory Committee noted that its position on specific aspects of projection disclosure would permit wide latitude to companies issuing projections and stated that the Commission should review and monitor projection disclosure to determine the utility to investors of such information and the costs to issuers.

The Commission's Views

The Commission concurs in the Advisory Committee's recommendation and findings. As noted by the Advisory Committee, the availability of forward-looking and analytical information is important to an investor's assessment of a corporation's future earning power and may be material to informed investment decision-making.[10] Projections and other types of forward-looking information are generally available within the investment community and are obtained and used by investors and their advisors.[11]

In addition, a majority of the commentators on the guides proposed in Release No. 5699 were in favor of a position that would permit the inclusion of projections in filings with the Commission by those issuers with the ability and willingness to make them.[12] Accordingly, in light of the significance attached to projection information and the prevalence of projections in the corporate and investment community, the Commission has determined to follow the recommendation of the Advisory Committee and wishes to encourage companies to disclose management projections both in their filings with the Commission and in general.[13] In order to further encourage such disclosure, the Commission has, in a separate release issued today, proposed for comment

10. *Report, supra* note 3, at 349-50.

11. The Advisory Committee's survey of individual investors indicated that nearly half of the investors surveyed favored disclosure in annual reports of a company's projected earnings per share for a full year. *Report* at 290. Similarly, the Advisory Committee staff survey of equity analysts indicated that management's projections of company performance are considered vital information in the first instance rather than simply confirmatory of analysts' own projections. *Report* at 55-57.

12. *See* comments collected in File No. S7-561.

13. The Advisory Committee also recommended that the Commission encourage the disclosure of other items of "soft information," such as planned capital expenditures and financing, management plans and objectives, statements of dividend policies, and statements of capital structure policies. See *Report* at 365-380. In this regard, guidelines for the disclosure of this information are being considered generally, as well as in connection with specific proposals to amend Guides 22 (Management Analysis of the Financial Statements) and 26 (Statement of Dividend Policy) to implement further the Advisory Committee's recommendations regarding soft information.

a safe-harbor rule for projection information whether or not included in Commission filings.[14] The Commission also has determined to authorize publication of revised staff guides to assist implementation of the Advisory Committee's recommendation. A summary of the recommendations of the Advisory Committee regarding particular aspects of projection disclosure, corresponding comments received on the guides as proposed in Release No. 5699 and in response to Release No. 5707,[15] and the position adopted in the final guides is set forth immediately below.

Discussion of the Staff's Guides Published Herein—Voluntary versus Mandatory Disclosure

In the proposed guides published in Release 33-5699, the Division of Corporation Finance set forth its view that management should have the option to present in Commission filings its good faith assessment of a company's future performance. The Advisory Committee and the commentators are in accord with the view that a voluntary projection system is more appropriate than a mandatory system. The Advisory Committee noted that a mandatory system would require the adoption of specific disclosure rules and regulations and felt that the Commission did not yet have an appropriate basis for formulating such requirements. In addition, the Committee did not believe that all companies should be required to sustain the expenses and burdens that might be associated with mandatory disclosure. Further, the Committee was of the view that many companies would find it difficult to prepare adequate projections due to lack of operating history, general economic factors, or industry conditions and should not be compelled to subject themselves to possible risks of liability for inaccurate projections.[16]

In view of the Advisory Committee's recommendation and the comments received, the proposed guides continue to reflect the position that disclosure of projections and other items of forward-looking information in Commission filings is permitted but not required.

However, the concern expressed in Release 33-5699 is reiterated regarding the selective disclosure of material non-public information; projection information should not be made available on a selective

14. Securities Act Release No. 5993. *See* Proposed Rules in this issue.

15. In Securities Act Release No. 5707, May 18, 1976, 41 FR 21370, comments were solicited by the Advisory Committee on the following question: "Should the SEC require corporate filings to set forth more forward-looking and analytical information regarding the company's business operations?" (Please consider the legal liability and competitive problems associated with such a requirement and whether such information should be reviewed by auditors.)

16. *Report, supra* note 3, at 354-55.

basis. Issuers have a further responsibility to make full and prompt disclosure of material facts regarding their financial condition, and this responsibility extends to situations where previously disclosed projections no longer have a reasonable basis.

Reporting Companies/Nonreporting Companies

The Commission's 1975 rule proposals included a three year Exchange Act reporting history and prior budgeting experience requirement in order to qualify for the safe harbor protection. Several commentators [17] took issue with this requirement, and suggested that projection information regarding new and promotional companies may be more significant in that forecast information may be most valuable regarding companies that do not have a history of public information.

Although the 1975 proposals were ultimately withdrawn, the guides proposed in Release 5699 indicated the Division's view that a history of operations or experience in projecting may be among the factors providing a reasonable basis for management's assessment of a company's future economic performance. Nevertheless, it would not appear that such history and experience would be necessary in all instances to provide reasonably based projections. Accordingly, the revised guides do not provide reporting, operating history, or other status criteria for those public companies desiring to make public projection disclosure.[18]

Disclosure of Assumptions

In paragraph (c) of the proposed guides the Division indicated its belief that investor understanding of the basis for and limitations of projections would be enhanced by disclosure of the assumptions which in management's opinion are significant to the projections or are the key factors upon which the financial results of the enterprise depend. The commentators generally were in accord with the position that disclosure of assumptions is perhaps the most significant factor in facilitating investor understanding. As noted by the Advisory Committee, such disclosure provides a framework for analysis of the projection and further reflects on management's planning capabilities. However, the Advisory Committee recommended that disclosure of assumptions be encouraged but not required, in order to make pro-

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17. Securities Act Release No. 5581, April 28, 1975, 40 FR 20316.

18. See *Report, supra* note 3, at 356. This result is consistent with the recommendations of the Advisory Committee.

jecting more attractive to registrants, until there is more experience with projection disclosure.[19]

While the Division believes that disclosure of assumptions would help investors to comprehend projections and assist in establishing a reasonable basis for projections disclosed, there may be instances where reasonably based and adequately presented projections would significantly add to the mix of information available to investors in the absence of disclosure of underlying assumptions. However, the Division believes under certain circumstances the disclosure of underlying assumptions may be material to an understanding of the projected results. For example, where projected results are based to a significant degree upon the introduction of a new product or service meeting certain anticipated levels of sales and contribution to earnings, disclosure of the projection without this information might be misleading.

Items to Be Projected

Paragraph (b) of the proposed guides indicated that traditionally projections have been given for three items generally considered to be of primary interest to investors: sales or revenues, net income, and earnings per share. These items usually are presented together in order to avoid any misleading inferences that may arise when individual items reflect contradictory trends. Although these three items usually are the key elements in an appropriate presentation of a projection, the Division recognizes that there may be circumstances when company management should be given flexibility in determining whether other or additional financial items should also be presented.[20]

Third Party Review

The proposed guides suggested that additional support for projections could be furnished through an outside review. If such a review were to be included, disclosure of the reviewer's qualifications, the

19. *Report, supra* note 3, at 358. The revised guides do not reflect the position that projections disclosed without assumptions are *per se* misleading. However, *Cf. Beecher* v. *Able,* 374 F. Supp. 341 (S.D.N.Y., 1974) wherein it was held that ". . . any assumptions underlying the projection must be disclosed if their validity is sufficiently in doubt that a reasonably prudent investor, if he knew of the underlying assumptions, might be deterred from crediting the forecast. Disclosure of such underlying assumptions is necessary to make . . . [the forecast] . . . not misleading." 374 F. Supp. at 348. However, it should be noted that the *Beecher* court went on to indicate that "[A]ll projections will be based on numerous assumptions, some of which are so reasonable and so likely to be borne out by the facts that they may be left unstated. *Id.* at n. 6.

20. See *Report, supra* note 3, at 362. The revised guides do not require that any specific items be projected. However, selective projection of only favorable items may create misleading inferences.

relationship of the reviewer to the registrant, and the extent of the review would be required. A reviewer would be deemed an expert and an appropriate consent would be required to be filed with a registration statement under the Securities Act, if the reviewed projection and report were included therein.[21]

A few commentators opposed outside review *per se*, suggesting that outside review could lend a false aura of greater credibility to projecting information. It was further suggested that "shopping" for favorable reviews would be possible under the proposed guides and that only those persons who can clearly demonstrate independence from management should be permitted to review projections.

The Advisory Committee concurred with the position on outside review as set forth in the proposed guides without further comment or recommendation. The final guides do not change this position on outside review.

Although the Division shares the expressed concern regarding relationship of reviewers to companies that make projections, it believes that outside review should be permitted, provided appropriate disclosures are made about relationships between reviewers and registrants.[22] In this regard, a person should not be named as an outside reviewer if he actively assisted in the preparation of the projection.

Revision and Updating of Projections

In Release 33-5699, the Commission reminded issuers of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition, and that this responsibility may extend to situations where management knows its previously disclosed assessments no longer have a reasonable basis. In addition, the proposed Guides recommended that investors be informed of management's intentions with respect to furnishing updated projections. Although the Advisory Committee concluded that periodic updating of projection information should not be required, it recommended that this position again be noted.[23]

The Advisory Committee also recommended that public companies

21. See Section 7 of the Securities Act of 1933. 15 U.S.C. 77g.

22. The guides, as published, call for disclosure of the qualifications of the reviewer, and the extent of the review in detail sufficient to indicate how the projection was analyzed and evaluated, and the basis for the conclusion reached. Disclosure is also required as to any other material factors concerning any aspect of the process by which any outside review was sought or obtained. Depending upon the facts, this provision might require disclosure of a registrant's unsuccessful efforts to obtain an outside review. Also, the Auditing Standards Division of the AICPA currently has standards for review of projections under consideration.

23. This recommendation is incorporated in the published guides.

be allowed to revise their projections while "in registration," and that current projections would be appropriately included in registration statements (updated as necessary) filed under the Securities Act.[24]

In Release 33-5180,[25] "Guidelines for the Release of Information by Issuers Whose Securities are in Registration," the Commission stated that issuers in registration should avoid the issuance of forecasts, projections, or predictions relating but not limited to revenues, income, or earnings per share. Although an issuer in registration should carefully consider all facts and circumstances in determining whether a projection could be deemed to constitute an offer in violation of Section 5 of the Act, to the extent the position expressed in Release 33-5180 would prevent issuers in registration from making projections or including them in their filings that position is superseded.

Time Period for Projections; Discontinuance and Resumption

The proposed guides did not suggest a specific time period that may be appropriately covered by a projection. Due to factors that vary among industries, companies disclosing projections should have the responsibility for selecting the most appropriate time period depending on all the facts and circumstances. The Advisory Committee concurred in the approach taken by the proposed guides and the final guides reflect this position.

The Advisory Committee was also of the opinion that the use of projections would be encouraged if companies were permitted to discontinue making projections. Changed business conditions may make sound projections possible in one year and impracticable in another. Accordingly, the final guides incorporate the Advisory Committee's recommendation, but indicate that companies should not discontinue or resume making projections in Commission filings without a reasonable basis for such action. In the view of the Division, if the registrant were to furnish projections only when they are favorable and not when they are unfavorable, this pattern of disclosure might be viewed as misleading.

Other Matters

Tax Shelters

In a footnote to the proposed guides in Release 33-5699,[26] it is stated that in view of the different considerations that apply to tax shelter

24. See *Report, supra* note 3, at 360-361.

25. Securities Act Release No. 5180, August 16, 1971, 36 FR 16506.

26. Securities Act Release No. 5699, *supra* note 7, at note 5.

investments, the guides would not apply to filings covering such securities. Meaningful projections for tax shelter investments may involve a much longer time period, with a correspondingly more limited accuracy and reliability; items to be projected other than those traditionally used, such as sales/revenues, net income, and earnings per share may be more relevant in considering these investments.

Accordingly, the guides as proposed and adopted have been formulated with regard to projections made outside the context of tax shelter investments. However, certain items may be capable of more accurate prediction in tax shelters (e.g., depreciation, amortization and debt service) and reasonably based and adequately presented projections of such items are not intended to be precluded.

Projections Required by Regulatory Authorities

Frequently issuers are required to submit projection information to other federal and state regulatory authorities. This information often is requested with respect to a lengthy time period, e.g., ten years or more. This information may often be publicly available and may consist of material the accuracy of which might be questionable, in view of the length of time covered, when considered from the viewpoint of investors. Accordingly, issuers have raised questions regarding their obligations under the federal securities laws with respect to this information.

While the submission of this type of information to federal or state regulatory authorities pursuant to their requirements under circumstances in which it would be publicly available would not in and of itself violate the federal securities laws or require issuers to make corresponding public projections in filings with the Commission or otherwise, issuers should consider their obligation to assure that material facts concerning its financial condition are promptly and fully disclosed and that the information submitted does not become misleading by virtue of subsequent events.[27]

Operation of the Guides

As indicated above, publication of the amended guides is intended to implement the position of the Commission and of the Advisory Committee that the making of projections be encouraged. Because of

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27. In this regard, issuers may wish to consider the appropriateness of clearly distinguishing such information from any projections already made, or clearly indicating that the information should not be considered as a projection for any purpose other than consideration by the requesting authority. In this connection, issuers may also wish to consider the appropriateness of filing a report on Form 8-K, 17 CFR 249.308, under Item 5, in which the furnishing of this information could be disclosed and the purpose of its submission and nature of its use clarified.

the Commission's responsibility to protect investors and safeguard the public interest in connection with sales and purchases of securities, the encouragement of projection information is an experiment and the relaxation of the Commission's policy in this area will be monitored. Since the amended guides substantially have been the subject of public comment, the guides will be effective immediately upon publication in the *Federal Register*. However, since the Commission is also proposing for comment a safe-harbor rule for projection disclosure (See Securities Act Release No. 5993 in this separate part), comment is also invited on the operation of the Guides in conjunction with the proposed rule. Comments should refer to File No. S7-760 and should be submitted in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. All comments will be available for public inspection.

Accordingly, 17 CFR Chapter II is amended as follows:

1. Part 231 is amended by adding Guide 62, "Disclosure of Projections of Future Economic Performance," to the Guides for Preparation and Filing of Registration Statements under the Securities Act of 1933 to read as follows:

Text of the Guides

Guide 62—DISCLOSURE OF PROJECTIONS OF FUTURE ECONOMIC PERFORMANCE

Preliminary Note

In furtherance of the Commission's policy of encouraging projections, as set forth in Securities Act Release No. 33-5992, this guide sets forth the views of the Division of Corporation Finance on the voluntary disclosure of projections of future economic performance in registration statements filed under the Securities Act of 1933. The Division encourages the use in registration statements of management's projections of future economic performance that have a reasonable basis and are presented in an appropriate format. The guidelines set forth herein represent the Division's views on important factors to be considered in formulating such projections.

The guides are not rules of the Commission nor are they published as bearing the Commission's official approval; they represent practices followed by the Commission's Division of Corporation Finance in administering the disclosure requirements of the federal securities laws.

1. Basis for Projections

The Division believes that management should have the option to present in Commission filings its good faith assessment of a registrant's future performance. Management must, however, have a reasonable basis for such an assessment. Although a history of operations or experience in projecting may be among the factors providing a basis for management's assessment, the Division does not believe that a company always must have had such a history or experience in order to formulate projections with a reasonable basis.

An outside review of management's projections may furnish additional support for having a reasonable basis for a projection. If management decides to include a report of such a review in the registration statement, there should also be disclosure of the qualifications of the reviewer, the extent of the review, the relationship between the reviewer and the registrant and any other material factors concerning the process by which any outside review was sought or obtained. Moreover, the reviewer would be deemed an expert and an appropriate consent must be filed with the registration statement.

2. Format for Projections

In determining the appropriate format for projections included in Commission filings, consideration must be given to, among other things, the financial items to be projected, the period to be covered, and the manner of presentation to be used. Although traditionally projections have been given for three financial items generally considered to be of primary importance to investors (revenues, net income and earnings per share), projection information need not necessarily be limited to these three items. However, management should take care to assure that the choice of items projected is not susceptible of misleading inferences through selective projection of only favorable items.

Revenues, net income, and earnings per share usually are presented together in order to avoid any misleading inferences that may arise when the individual items reflect contradictory trends. There may be instances, however, when it is appropriate to present earnings from continuing operations, or income before extraordinary items in addition to or in lieu of net income. It generally would be misleading to present sales or revenue projections without one of the foregoing measures of income.

The period that may appropriately be covered by a projection depends to a large extent on the particular circumstances of the company involved. For certain companies in certain industries, a projection covering a two or three year period may be entirely reasonable. Other companies may not have a reasonable basis for projections beyond the current year. Accordingly, management should select the period most appropriate in the circumstances. In addition, management in making a projection should disclose what in its opinion is the most probable specific amount or the most reasonable range for each financial item projected based on the selected assumptions. Ranges should not, however, be so wide as to make the disclosures meaningless. Moreover, several projections based on varying assumptions may be judged by management to be more meaningful than a single number or range and would be permitted.

3. Investor Understanding

When management chooses to include its projections in a Commission filing, the disclosures accompanying the projections should facilitate investor understanding of the basis for and limitations of projections. In this regard investors should be cautioned against attributing undue certainty to management's assessment, and the Division believes that investors would be aided by a statement indicating management's intention regarding the furnishing of updated projections. The Division also believes that investor understanding would be enhanced by disclosure of the assumptions which in management's opinion are most significant to the projections or are the key factors upon which the financial results of the enterprise depend, and encourages disclosure of assumptions in a manner that will provide a framework for analysis of the projection.

Management should also consider whether disclosure of the accuracy or inaccuracy of previous projections would provide investors with important insights into the limitations of projections. In this regard, consideration should be given to presenting the projections in a format that will facilitate subsequent analysis of the reasons for differences between actual and forecast results. An important benefit may arise from the systematic analysis of variances between projected and actual results on a continuing basis, since such disclosure may highlight for investors the most significant risk and profit-sensitive areas in a business operation.

With respect to previously issued projections, registrants are reminded of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition. This responsibility may extend to situations where management knows or has reason to know that its previously disclosed projections no longer have a reasonable basis.

Since a company's ability to make projections with relative confidence may vary with all the facts and circumstances, the responsibility for determining whether to discontinue or resume making projections is best left to management. However, the Division encourages companies not to discontinue or resume projections in Commission filings without a reasonable basis.

2. Part 241 is amended by adding Guide 5, "Disclosure of Projections of Future Economic Performance," to the Guides for the Preparation and Filing of Reports and Proxy and Registration Statements under the Securities Exchange Act of 1934 to read as follows:

Guide 5–GUIDES FOR THE PREPARATION AND FILING OF REPORTS AND PROXY AND REGISTRATION STATEMENTS UNDER THE SECURITIES EXCHANGE ACT OF 1934

DISCLOSURE OF PROJECTIONS OF FUTURE ECONOMIC PERFORMANCE

[The guide is identical to Guide 62 except (1) the first sentence of the Preliminary Note refers to "registration statements, reports, and proxy statements filed under the Securities Exchange Act of 1934," and (2) the last sentence of the second paragraph under the caption "Basis for Projections" concerning the filing of a consent by the reviewer-expert would be omitted.]

Authorization of Publication for Guides

The Commission hereby authorizes publication of Guides 62 and 5, pursuant to the Securities Act of 1933, particularly sections 7 and 10 thereof, and the Securities Exchange Act of 1934, particularly sections 12, 13, 15(d) and 23(a).

(Secs. 7, 10, 48 Stat. 78, 81; secs. 12, 13, 15(d), 23(a), 48 Stat. 892, 894, 895, 901; sec. 205, 48 Stat. 906; sec. 203(a), 49 Stat. 704; secs. 1, 3, 8, 49 Stat. 1375, 1377, 1379; secs. 8, 202, 68 Stat. 685, 686; secs. 3, 4, 10, 78; secs. 1, 2, 28(c), 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 10, 18, 89, Stat. 117, 118, 119, 155; 15 U.S.C. 77g, 77j, 78l, 78m, 78o(d), 78w(a).)

By the Commission.

George A. Fitzsimmons
Secretary

SECURITIES ACT OF 1933

SECURITIES ACT OF 1933
Rel. No. 6084/June 25, 1979

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 15944/June 25, 1979

PUBLIC UTILITY HOLDING CO. ACT OF 1935
Rel. No. 21115/June 25, 1979

TRUST INDENTURE ACT OF 1939
Rel. No. 532/June 25, 1979

SAFE HARBOR RULE FOR PROJECTIONS

AGENCY: Securities and Exchange Commission.

ACTION: Final rules.

SUMMARY: The Commission is adopting a rule providing a safe harbor from applicable liability provisions of the federal securities laws for statements made in filings with the Commission or in annual reports to shareholders that contain or relate to projections. In general, statements containing or relating to (i) projections of certain financial items, (ii) management plans and objectives, (iii) future economic performance included in management's discussion and analysis of the summary of earnings and (iv) disclosed assumptions underlying or relating to these statements would be deemed not to be false or misleading under the federal securities laws unless they were prepared without a reasonable basis or disclosed other than in good faith. The rule is being adopted in order to further the Commission's goal of encouraging the disclosure of projections and forward looking information both in Commission filings and in general.

EFFECTIVE DATE: July 30, 1979.

FOR FURTHER INFORMATION CONTACT: John J. Heneghan, Office of the Chief Counsel, Division of Corporation Finance, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549 (202) 755-1240.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today adopted a rule designed to provide a safe harbor from the applicable liability provisions of the federal securities laws for statements relating to or containing (1) projections of revenues, income (loss), earnings (loss) per share or other financial items, such as capital expenditures, dividends, or capital structure, (2) management plans and objectives for future company operations, and (3) future economic performance included in management's discussion and analysis of the summary of earnings or quarterly income statements.[1] The rule is based on the alternatives that were proposed in Securities Act Release No. 5993 (November 7, 1978) (43 FR 53251).[2] The rule is adopted in furtherance of the Commission's goal of encouraging the disclosure of projections and other items of forward-looking information.[3] In a related action, the Commission is withdrawing the reference in note (a) to Rule 14a-9 (17 CFR 240.14a-9) to prediction of dividends as a possible example of a false or misleading statement. This release contains a brief discussion of the background of the proposed rules, the view of the commentators, and the provisions of the rule as adopted.

Background and Purpose

In Securities Act Release No. 5699, the Commission published for comment proposed Guides for projection disclosure and stated its belief that reasonably based and adequately presented projections should not subject issuers to liability under the federal securities laws solely because the projected results did not materialize.[4] In this regard, the Commission noted that even the most carefully prepared and thoroughly documented projections may prove inaccurate. Several of the commentators responding to the release urged the adoption of a

1. Guides 22 and 1 under the Securities Act of 1933 (the "Act") (15 U.S.C. 77a et seq. as amended by Pub. L. No. 94-29, June 4, 1975) and the Securities Exchange Act of 1934 (the "Exchange Act") (15 U.S.C. 78a et seq. as amended by Pub. L. No. 94-29, June 4, 1975), state that the analysis of the summary of earnings required by certain registration statements and reports such as those filed on Forms S-1, S-7, 10, and 10-K should include a discussion of material facts, whether favorable or unfavorable, required to be disclosed or disclosed in the prospectus which, in the opinion of management, may make historical operations or earnings as reported in the summary of earnings not indicative of current or future operations or earnings. In addition, Instruction 5 to Part I of Form 10-Q (17 CFR 249.308a) calls for an analysis of the quarterly income statements included in that form. Instruction 6 to Form 10-Q states that management also may furnish any additional information related to the periods being reported on which, in its opinion, is significant to investors.

2. On the same day that the "safe harbor" rules were proposed, the Commission also published revised Guides 62 and 5, "Disclosure of Projections of Future Economic Performance," under the Act and the Exchange Act. Securities Act Release No. 5992 (November 7, 1978) (43 FR 53246). The Guides set forth the views of the Division of Corporation Finance regarding important factors to be considered in disclosing projections of future company economic performance in reports and other Commission filings.

3. See Securities Act Release No. 5992, November 7, 1978, 43 FR 53246.

4. Securities Act Release No. 5699, 41 FR 19986, April 23, 1976. The proposed guides were revised and adopted in Securities Act Release No. 5992, *supra*.

safe harbor rule for projections made by issuers and reviewed by third parties, stating that the absence of a safe harbor rule might discourage the dissemination of projections.

While the proposed Guides were pending, the Commission's Advisory Committee on Corporate Disclosure also considered the subject of disclosure of forward looking information. In its final report, the Advisory Committee concurred with the Commission's views, recommending, however, the adoption of a safe harbor rule in order to encourage voluntary projection disclosure. Accordingly, at the time revised staff guides were published in final form, the Commission proposed its own safe harbor rule for comment in Release 33-5993 while at the same time requesting comments on the Rule recommended by the Advisory Committee in its final report. Both rules as proposed would provide protection to statements, whether or not included in filings with the Commission.

The Commission's proposed rule provided that for purposes of applicable liability provisions of the federal securities laws [5] a statement containing a projection of revenues, income (loss), and earnings (loss) per share would be deemed not to be an untrue statement of a material fact, a statement false or misleading with respect to any material fact, an omission to state a material fact necessary to make a statement not misleading, or the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act, practice, course of business, or an artifice to defraud as those terms are used in the applicable statutory provisions or any rules thereunder if the statement (1) was prepared with a reasonable basis and (2) was disclosed in good faith. As proposed, the rule applied to projections made by issuers (other than registered investment companies): (1) with a class of securities registered pursuant to Section 12 of the Exchange Act, (2) the securities of which are exempt from that Act under Section 12(g)(2)(G) thereof or (3) which are subject to the reporting requirements of Section 15(d) of the Exchange Act. An additional eligibility standard of the proposed rule required the issuer to have filed all the material required to be filed under sections 13, 14, or 15(d) of the Exchange Act at the time the statement is made. The proposed rule also would have extended to statements made on behalf of the issuer at the issuer's request such as statements made by the third party reviewers.

The Advisory Committee's rule provided protection for a wider variety of forward looking information than was covered by the Commission's proposed rule. The Advisory Committee's rule would have

5. See secs. 11, 12 and 17 (15 U.S.C. 77k, 1, and g) of the Securities Act of 1933; secs. 10, 18, and 20 (15 U.S.C. 78j, r, and t) of the Securities Exchange Act of 1934; sec. 16 (15 U.S.C. 79p) of the Public Utility Holding Company Act of 1935; and sec. 323 (15 U.S.C. 77ssw) of the Trust Indenture Act of 1939.

applied to statements of management concerning future company economic performance or of management plans and objectives for future company operations. The Advisory Committee rule also was not conditioned on status as a reporting company or currency of filings. Most significantly, the Advisory Committee rule had a different burden of proof. The rule would have deemed a statement not to be false or misleading under the federal securities laws unless the statement was prepared without a reasonable basis or was disclosed other than in good faith. Thus the burden of proof would have been on the plaintiff to show lack of a reasonable basis and absence of good faith.

In proposing alternative formulations, the Commission requested comment as to which format would further the goal of encouraging projection disclosure in a manner consistent with investor protection. Over ninety detailed letters of comment were received and considered by the Commission.[6] The following portions of the release discuss the major differences between the alternative proposals, the views of the commentators, the Commission's responses, and the rule adopted today.

General

In general, the commentators supported the Commission's effort to implement the Advisory Committee's recommendation to encourage the disclosure of projections and forward-looking information. However, some commentators expressed concern that, despite the voluntary nature of the program, companies choosing not to make projections might face pressure to do so, as other companies begin to disclose forward looking information. In addition these commentators were concerned that undue reliance may be placed on projections by investors. Notwithstanding these concerns, there was widespread support for the adoption of a safe harbor rule. By and large, the commentators shared the Advisory Committee's view that a safe harbor provision is needed if the Commission's goal of encouraging the disclosure of projections is to be realized. Most commentators favored the adoption of a rule that would incorporate aspects of each alternative rule proposed, and the rule adopted today incorporates aspects of both alternative formulations. Specific portions of the final rule are discussed immediately below.

Burden of Proof

The Commission's proposed rule placed the burden of proof on the defendant to prove that a projection was prepared with a reasonable basis and was disclosed in good faith. The proposed rule reflected the Commission's concern as to the difficulties faced by plaintiffs since the facts are in the exclusive possession of the defendants.

6. See comments collected in file No. S7-760.

The Advisory Committee rule would place the burden of proof on the plaintiff, along the lines of the Commission's existing safe harbor rules for replacement cost information and oil and gas reserve disclosures under Regulation S-X.[7]

This aspect of the proposed rules drew the most comment. Virtually all of the commentators expressed support for the Advisory Committee's formulation that would place the burden of proof on the plaintiff to establish the absence of a reasonable basis and good faith. Most commentators were of the view that the Commission's proposed rule would deter companies from making projections, thereby negating the Commission's objective. These commentators also believed that the Commission's proposed rule would in all likelihood increase the institution of frivolous, nuisance litigation based solely on the failure of the results to match projections, with a resulting cost and time burden to be borne by registrants.

Many commentators also took issue with the premises of the Commission's proposed rule, i.e., the concern that the burden of proof for plaintiffs might be insurmountable. These commentators asserted that the burden on a prospective plaintiff is not onerous in light of the current liberal discovery procedures available in federal courts as well as the Commission's broad investigatory powers. They also pointed out that cases involving projection disclosure have shown that discovery procedures and availability of public information have afforded plaintiffs an adequate basis to prove their cases against defendants.[8] In the view of some commentators, the proposed rule was in fact narrower than existing law and would afford less protection than no rule at all.

In view of the Commission's overall goal of encouraging projection disclosure and in light of the factors cited by the commentators, the Commission has determined to adopt the standard recommended by the Advisory Committee. The Commission's initiatives in projection disclosure are experimental in nature and will be watched closely to assure that the new policies embodied therein, including the adoption of this rule, do not yield results inconsistent with investor protection.[9]

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7. 17 CFR 210.3-17(g) and 210.3-18(k)(6)(v) respectively.

8. See, e.g., *Marx* v. *Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974); *Beecher* v. *Able*, 374 F.Supp. 341 (S.D.N.Y., 1974); *Green* v. *Jonnop*, 358 F.Supp. 413 (D. Ore. 1973).

9. With respect to forward looking statements, the rule interprets various terms of the liability provisions of the federal securities laws to require a showing that a forward looking statement was prepared without a reasonable basis and disclosed other than in good faith. If a plaintiff seeking to establish liability on the basis of a forward looking statement can make such a showing, he and the defendant must still meet whatever standards are applicable in the circumstances of the particular claim and the relief sought. *See e.g.*, Sections 12, and 17 [15 U.S.C. 771 and g] of the Securities Act and Sections 10, 18 and 20 [15 U.S.C. 78j, r, and t] of the Exchange Act.

Retention of Good Faith Requirement

Both the Commission's and the Advisory Committee's proposed rules require that reasonably based projections be disclosed in good faith. Several commentators believed that no objective standard exists for determining whether the "good faith" portion of the requirement has been met and that the term was ambiguous at best. Some commentators did not see how a reasonably based projection could be prepared and disclosed other than in good faith, and suggested that if a projection were found to have been prepared and disclosed with a reasonable basis, good faith disclosure is implicit.

On balance, the Commission believes that in light of the experimental nature of its program to encourage projection disclosure and the possibility of undue reliance being placed on projections, the use of good faith standard in the rule is appropriate. The Commission also notes that there is ample precedent for the concept of good faith in other provisions of the federal securities laws.[10]

Nature of Information Protected by the Rule

The Commission's proposed rule related only to projections of revenues, income (loss), earnings (loss) per share or other financial items. The Advisory Committee's proposed rule refers generally to statements of "management projection[s] of future company economic performance" or of "management plans and objectives for future company operations," and corresponds with that Committee's recommendation that disclosure of other types of forward looking information beyond those items customarily projected also should be encouraged.

Most commentators favored protecting a broader category of forward looking items than included in the Commission's proposed rule. Several suggested that since the Guides state that projections need not be limited to the three items traditionally presented, the scope of the safe harbor rule should correspond with this position. The commentators also were unsure of whether the phrase "other financial items" as used in the Commission's proposed rule was intended to cover the items referred to by the Advisory Committee.

At the time the alternative rules were proposed, the Commission noted that guidelines for the disclosure of these additional categories of forward looking information were under general consideration, as well as in connection with possible amendments to guides 22 (Man-

10. For example, Section 20(a) of the Exchange Act (15 U.S.C. 78t(a)) imposes liability on control persons for violations of that Act by persons controlled, unless the controlling person acted in good faith and did not directly induce the act or acts constituting the violation. Sections 18(a) and 78bb(e)(1) respectively and Section 2(a)(41)(A) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(41)(A)) also incorporate the concept of good faith determination.

agement Analysis of the Financial Statements) and 26 (Statement of Dividend Policy), and that safe harbor provisions would be considered when further proposals relating to other categories of forward-looking information were published for comment. Although specific guidelines relating to additional types of forward looking information are still under consideration, the Commission has determined that the scope of the safe harbor rule can be expanded at this time to cover those types of information that the commentators and the Advisory Committee urged should be within the protection of the rule. Accordingly, the rule adopted today expands the items in the proposed rule to cover projections of other financial items such as capital expenditures and financing, dividends, and capital structure,[11] statements of management plans and objectives for future company operations, and future economic performance included in management's discussion and analysis of the summary of earnings or quarterly income statements.[12] The rule has been revised to refer specifically to these other items of forward looking information in light of the commentators' suggestions that the broader coverage of the Advisory Committee rule be made explicit.

Disclosure of Assumptions

In Release 33-5992, the Commission emphasized the significance of disclosure of the assumptions that underlie forward-looking statements. As indicated in that release and Guide 62, disclosure of assumptions is believed to be an important factor in facilitating investors' ability to comprehend and evaluate these statements.

While the Commission has determined to follow the Advisory Committee's recommendation that disclosure of assumptions not be mandated under all circumstances, it wishes to re-emphasize its position on the significance of assumption disclosure. Under certain circumstances the disclosure of underlying assumptions may be material to an understanding of the projected results. The Commission also believes that the key assumptions underlying a forward looking statement are of such significance that their disclosure may be necessary in order for such statements to meet the reasonable basis and good faith standards embodied in the rule. Because of the potential importance of assumptions to investor understanding and in order to encourage

11. In this connection, the Commission today has published proposed staff guidelines for disclosure in registration statements and reports filed by electric and gas utility companies. Securities Act Release No. 6085, see Proposed Rules in this issue. These proposed guidelines expressly request disclosure of certain forward looking information which would be covered by the safe-harbor rule adopted today.

12. *See* note 1 supra.

their disclosure, the rule as adopted indicates specifically that disclosed assumptions also are within its scope.[13]

Persons Covered by the Rule

The Commission's proposed rule was intended to protect statements made "by or on behalf of" the issuer in order to include statements of an outside reviewer of management's projections. The Advisory Committee's rule applied to management statements and does not specifically apply to statements by third party reviewers or define "management."

Most of the commentators believed that reviewers should be afforded protection under the rule and many suggested that the text of the final rule should specifically refer to reviewers. Based on a review by the Commission of these comments and of the issues involved, the final rule refers to statements made by or on behalf of an issuer or by an outside reviewer retained by the issuer.[14]

Companies Eligible for Protection

As proposed, the rule would have applied only to statements made if at the time of such statement a class of the registrant's securities was registered under Section 12(b) or (g) of the Exchange Act (or exempt from registration under Section 12(g)(2)(G) thereof), or the issuer was subject to the reporting requirements of Section 15(d) of the Exchange Act. The proposed rule would not have been available to statements made with respect to investment companies registered under the Investment Company Act of 1940.[15] As noted above, the availability of the Advisory Committee rule was not conditioned on a particular company's reporting or other status.

The Commission proposed the rule in this fashion, stating that projections might best be evaluated in the context of financial and other information about the company that is likely to be available through

13. Assuming that a forward-looking statement is otherwise made with a reasonable basis and in good faith, the failure to disclose one or more assumptions should not result in any difference in the burden of coming forward. In most, if not all cases, assumptions are an integral part in the formulation of forward-looking information. Disclosure or nondisclosure does not alter this relationship. Consequently, the language in the rule affording protection to disclosed assumptions should not be interpreted to create a negative inference that disclosure of forward-looking information without accompanying disclosure of assumptions is not protected. That language was included in the rule to make it clear that the entire disclosure which is made is protected and to afford maximum incentive to the voluntary disclosure of assumptions.

14. As indicated in Release 33-5992, relationships between a reviewer and the issuer should, of course, be disclosed. It should be noted that the final rule does not, in any event, cover statements concerning the relationship between the issuer and an outside reviewer.

15. 15 U.S.C. 80a et seq.

Exchange Act reports directly or other information sources that reflect the information contained in such reports.

Although some commentators were of the view that there should be no company status limitations and that forward looking information may be particularly important in assessing new enterprises, some commentators did not object to conditioning the availability of the rule on the existence of a reporting history, at least as an initial step. However, many questioned the propriety of limiting the availability of the rule to reporting companies while suggesting in the Guides that the absence of a history of operations or experience in projecting need not preclude an issuer from preparing projections with a reasonable basis.[16]

The Commission has considered the views of the commentators and agrees that the safe harbor rule should be available to as many companies as possible. However, the Commission is also concerned that there be a sufficient informational context in which a projection can be assessed and evaluated by investors, analysts, and others. Accordingly, the Commission has determined to make the rule available to reporting companies and has expanded the availability of the rule to non-reporting companies who include forward-looking statements in registration statements filed under the Securities Act, such as first time registrants using Form S-1 or Form S-18.[17]

Statements made by such companies in registration statements, Exchange Act reports, annual reports to shareholders, and other documents filed with the Commission will be covered by the rule. The rule also will be available for disclosures or reaffirmations of these forward-looking statements made at subsequent times, provided, of course, that such disclosures or reaffirmations meet the standards of reasonable basis and good faith at the time they are subsequently disclosed or reaffirmed. Statements made outside of these documents will be covered by the rule only if they are included in documents filed with the Commission or, for those companies the securities of which are registered pursuant to Section 12 of the Exchange Act, in annual reports to shareholders meeting the requirements of Rule 14a-3(b) and (c) or Rule 14c-3(a) and (b) under the Exchange Act.[18]

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16. See Guides 62 and 5, paragraph 1, Securities Act Release No. 5992, 43 FR 53246, November 7, 1978.

17. 17 CFR 239.11 and 17 CFR 239.28 respectively. Absent voluntary or mandatory registration under Section 12 of the Exchange Act, 15 USC 78l, first time registrants are not subject to the reporting provisions of that Act until their Securities Act registration statements have become effective. See Section 15(d) of the Exchange Act, 15 USC 78o(d), and Rules 15d-11 and 15d-13 respectively.

18. Rules 14a-3(c) and 14c-3(b) under the Exchange Act (17 CFR 240.14a-3(c) and 240.14c-3(b) respectively) provide that annual reports to shareholders are not deemed to be "filed" with the Commission or subject to the liabilities of Section 18 of that Act except to the extent an issuer specifically requests that

The Commission believes that the inclusion of forward-looking statements in filed documents and annual reports will provide investors with a better framework for their analysis through the context of certified financial statements and other disclosures appearing in registration statements and reports. In addition, staff review of those documents and the liability provisions of the Securities Act with respect to registration statements will help to assure that disclosure of forward-looking information will be made with greater care.

In addition, linking the availability of the rule for statements made outside of filed documents to subsequent inclusion in such documents reflects the Commission's continuing concern regarding the selective disclosure of forward-looking information. The inclusion of forward-looking statements in these documents will promote greater accessibility to this information for all investors.

Duty to Correct

As indicated in Release 33-5992, the Commission reminded issuers of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, where management knows or has reason to know that its earlier statements no longer have a reasonable basis. With respect to forward-looking statements of material facts made in relation to specific transactions or events (such as proxy solicitations, tender offers, and purchases and sales of securities), there is an obligation to correct such statements prior to consummation of the transaction where they become false or misleading by reason of subsequent events which render material assumptions underlying such statements invalid. Similarly, there is a duty to correct where it is discovered prior to consummation of a transaction that the underlying assumptions were false or misleading from the outset.

Moreover, the Commission believes that, depending on the circumstances, there is a duty to correct statements made in any filing, whether or not the filing is related to a specified transaction or event, if the statements either have become inaccurate by virtue of subsequent events, or are later discovered to have been false and misleading from the outset, and the issuer knows or should know that persons are continuing to rely on all or any material portion of the statements.[19]

This duty will vary according to the facts and circumstances of

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it be treated as part of the proxy soliciting material or incorporates it by reference into the proxy statement.

19. *See, e.g., Ross* v. *A. H. Robins Co., Inc.*, CCH Fed. Sec. L. Rep. ¶96,737 (S.D.N.Y. 1979), *appeal pending,* (2d Cir. No. 79-7106) [annual reports and prospectuses], *SEC* v. *Shattuck Denn Mining Corp.*, 297 F. Supp. 470 (S.D.N.Y. 1968) (press release). *See also Fischer* v. *Kletz,* 226 F. Supp. 180 (S.D.N.Y. 1967) (accountant's failure to disclose subsequent finding of falsity in certified financial statements included in annual reports to shareholders and Form 10-K).

individual cases. For example, the length of time between the making of the statement and the occurrence of the subsequent event, as well as the magnitude of the deviation, may have a bearing upon whether a statement has become materially misleading.

Current Filings Requirement

Several commentators questioned the appropriateness of the proposed requirement that Exchange Act reporting companies must have filed all annual, periodic, and other reports under that Act in order to be eligible for the safe harbor rule. Some were concerned that an inadvertent or immaterial filing delay could operate to deprive a company of protection under the rule for a statement that may fully meet the substantive standards of the rule. In this connection, other commentators did not perceive a strong relationship between the preparation of forward-looking statements and currency of Exchange Act filings.

While the existence of current Exchange Act reports also will provide additional information with which to assess forward-looking statements, the Commission agrees that the availability of the safe harbor rule should not be dependent upon a technical or immaterial circumstance. Accordingly, it has determined not to adopt the requirement that reporting companies be current in all Exchange Act filings. However, in light of certified financial statements and other extensive disclosure contained in annual reports on Form 10-K [17 CFR 249.310] that could provide contextual information for evaluation of forward-looking statements, the rule requires that reporting companies must have filed their most recent Form 10-K in order to be eligible for the safe harbor. Although no other requirement for currency of Exchange Act filings is adopted, the Commission believes that serious delinquency in filing or deficiency in content of Exchange Act filings may significantly impair a registrant's ability to prepare and disclose forward-looking statements with a reasonable basis.

Investment Companies

Those commentators who addressed the investment company issue expressed mixed views regarding the advisability of including investment companies in the safe-harbor rule. Some commentators did not perceive a basis for distinguishing between investment companies and other issuers and believed that the standard of reasonableness and good faith should be the appropriate benchmark for all companies.

Other commentators believed that the type of information generated by investment companies would be more difficult to forecast with reliability and is dependent upon market factors and responses to market events that are inherently unpredictable.

While the Commission does not believe that investment companies by definition are not capable of preparing reasonably based projections capable of disclosure in an appropriate format, it is of the view that the nature of information reported by investment companies is sufficiently distinct to warrant separate consideration. Accordingly, the Commission has determined not to extend the safe-harbor rule to investment company projections at this initial, experimental stage of its efforts to encourage disclosure of forward looking information. As experience is gained with disclosure of forward looking information by other companies, the Commission will consider whether an extension of the rule to investment companies is appropriate and whether separate guides for disclosure of projection by investment companies can be developed.

Effective Date and Operation

The rule will be effective for statements made on or after July 30, 1979. In view of the Commission's responsibility to protect investors and safeguard the public interest in connection with purchases and sales of securities, the adoption of these rules is in the nature of an experiment. The operation of the guides and the rules will be watched closely to limit their availability if the protection of investors so requires. The Commission anticipates that as the staff gains further experience with disclosure of forward-looking information, it will recommend the publication of such guidelines or interpretive releases on specific aspects of such disclosure in order to provide guidance to issuers.

Authority

The Commission is adopting the rules pursuant to its authority under Section 19(a) of the Securities Act of 1933 (15 U.S.C. 77s(a)), Sections 3(b) and 23(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78c and 78w(a)(1)), Section 20 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79t), and Section 319(a) of the Trust Indenture Act of 1939 (15 U.S.C. 77sss(a)). In addition to the definitional authority provided therein, Section 19(a) of the Securities Act, Section 23(a)(1) of the Exchange Act, Section 20(d) (15 U.S.C. 79t(d)) of the Holding Company Act and Section 319(c) of the Trust Indenture Act (15 U.S.C. 77sss(c)) provide that no liability under these acts "shall apply to any act done or omitted in good faith in conformity," with any rule or regulation of the Commission notwithstanding that such rule or regulation may later be amended, rescinded or determined invalid.

Pursuant to Section 23(a)(2) of the Exchange Act (15 U.S.C. 78w(a)(2)), the Commission has considered the effect that the rules would have on competition and is not aware at this time of any burden that the rules would impose on competition not necessary or appropriate in furtherance of the purposes of that Act.

Text of the Rules

Title 17 of the Code of Federal Regulations is amended by adding the following sections to parts 230, 240, 250 and 260.

Part 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933 §230.175. Liability for forward-looking statements by issuers.

(a) A statement within the coverage of paragraph (b) below which is made by or on behalf of an issuer or by an outside reviewer retained by the issuer shall be deemed not to be a fraudulent statement (as defined in paragraph (d) below), unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.

(b) This rule applies to (1) a forward looking statement (as defined in paragraph (c) below) made in a document filed with the Commission or in an annual report to shareholders meeting the requirements of Rules 14a-3(b) and (c) or 14c-3(a) and (b) under the Securities Exchange Act of 1934, (2) a statement reaffirming the forward looking statement referred to in (b)(1) subsequent to the date the document was filed or the annual report was made publicly available, or (3) a forward looking statement made prior to the date the document was filed or the date the annual report was made publicly available if such forward looking statement is reaffirmed in a filed document or annual report made publicly available within a reasonable time after the making of such forward looking statement.

(c) For the purpose of this rule the term "forward looking statement" shall mean and shall be limited to:

(1) a statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;

(2) a statement of management's plans and objectives for future operations;

(3) a statement of future economic performance contained in management's discussion and analysis of the summary of earnings (as called for by Guides 22 and 1 under the Securities Act of 1933 and the Securities Exchange Act of 1934 and by instruction 5 to the Quarterly Report on Form 10-Q); or

(4) disclosed statements of the assumptions underlying or relating to any of the statements described in (1), (2), or (3) above.

(d) For the purpose of this rule the term "fraudulent statement" shall mean a statement which is an untrue statement of a material fact, a statement false or misleading with respect to any material fact, an omission to state a material fact necessary to make a statement not misleading, or which constitutes the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act, practice, course of business, or an artifice to defraud, as those terms are used in the Securities Act of 1933 or the rules or regulations promulgated thereunder.

(e) Notwithstanding any of the provisions of paragraphs (a) through (d), this rule shall apply only to forward looking statements made by or on behalf of an issuer if, at the time such statements are made or reaffirmed, the issuer is subject to the reporting requirements of the Securities Exchange Act of 1934 and has filed its most recent annual report on Form 10-K, or, if the issuer is not subject to the reporting requirements of the Securities Exchange Act of 1934, the statements are made in a registration statement filed under the Securities Act of 1933.

(f) Notwithstanding any of the provisions of paragraphs (a) through (e), this rule does not apply to statements made by or on behalf of an issuer that is an investment company registered under the Investment Company Act of 1940.

Part 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

§ 240.3b-6 Projections of future economic performance by issuers.

(The text of the rule is identical to that above except that reference to the Securities Act of 1933 in paragraph (d) should read "Securities Exchange Act of 1934.")

§240.14a-9 False or misleading statements.

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NOTE: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section.

(a) Predictions as to specific future market values.

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Part 250—GENERAL RULES AND REGULATIONS, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

§250.103A Projections of future economic performance by issuers.

(The text of the rule is identical to that above except that reference to the Securities Act of 1933 in paragraph (d) should read "Public Utility Holding Company Act of 1935 and other acts referred to in Section 16(b) thereof.")

Part 260—GENERAL RULES AND REGULATIONS, TRUST INDENTURE ACT OF 1939

§260.0-11 Projections of future economic performance by issuers.

(The text of the rule is identical to that above except that reference to the Securities Act of 1933 in paragraph (d) should read "Trust Indenture Act of 1939 and other acts referred to in Section 323(b) thereof.")

[secs. 19(a), 3(b), 23(a)(1), 20, 319(a), 48 Stat. 85, 882, 901; sec. 209, 48 Stat. 908; 49 Stat. 833; sec. 203(a), 49 Stat. 704; sec. 8, 49 Stat. 1379; 53 Stat. 1173; secs. 3, 18, 89 Stat. 97, 155; sec. 308(a)(2), 90 Stat. 57; 15 U.S.C. 77s(a), 78c(b), 78w(a)(1), 79t, 77sss(c)].

By the Commission.

George A. Fitzsimmons
Secretary

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