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Anne J. Rich

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New Rules for Public CPAs and Implications for Management Accountants

By Anne J. Rich

Historical financial statements have developed from decades of input from professional associations, public accountants, management accountants and the government. While historic financial statements remain in a state of constant change, most users understand the basic statement of financial position, income statement and statement of changes in financial position. In addition, the three levels of service public accounting firms offer, namely audit, compilation and review, are also familiar to most users of historical financial statements. However, when we move from historical financial statements to prospective financial statements, our understanding is clouded by a lack of uniformity, unclear definitions, and until recently, an absence of authoritative accounting rules for reporting. Two recent AICPA pronouncements, *Guide for Prospective Financial Statements (1986)* and *Statement on Standards for Accountants' Services on Prospective Financial Information* will change the way public accountants are associated with forecasts and projections. They will also impact on the design of forecasting systems in many business organizations.

Definitions

Any financial information about the future is called prospective. Prospective financial information that is properly formatted to present financial position, results of operations and changes in financial position is referred to as a prospective financial statement.

The AICPA has differentiated between forecasts and projections. They define a forecast as a prospective financial statement that presents, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and changes in financial position. On the other hand, a projection is a prospective financial statement that reflects one or more hypothetical assumptions that the responsible party does not believe will actually occur. (The responsible party is anyone who is responsible for the assumptions used to make the forecast or projection; the party could be management but may be someone outside the entity).

Forecasting Systems

Over a decade ago, the AICPA established the foundation for their current position. Early significant literature included *Presentation and Disclosure of Financial Forecasts* and *Systems for the Preparation of Financial Forecasts*. The latter document identified ten important characteristics of the system that generates the forecast. Modified somewhat and extended to include all prospective financial statements, the ten guidelines are important to both management accountants who design the system and the public accountants who must analyze the strengths and weaknesses of this planning and control system. The guidelines appear in Exhibit 1.

Presentation and Disclosure

Rules for presentation and disclosure for forecasts have also existed for more than a decade. The latest pronouncements have extended the presentation and disclosure requirements to projections. No prospective statement may be issued without a summary of significant assumptions. The amount of additional information disclosed as well as the type of prospective statement issued depend on whether the statements are for general use or limited use. General users are those with whom the responsible party is not negotiating directly, such as unknown potential stockholders. Limited users are persons with whom the responsible party is negotiating directly, such as a banker. There will be special rules for internal use only documents which are provided for management's information.

Since general users, such as potential stockholders and creditors, rely heavily on prospective financial statements because they do not have access to management, the AICPA felt strongly about protecting these users. They concluded that while a financial forecast with all the required disclosures is adequate for the general user, a single financial projection may be misleading. Therefore, for general users, a single projection is prohibited. Instead, a set of projections may be sufficient as long as the hypothetical assumptions result in a reasonable range and the reader is alerted that the range presented in the statements does not guarantee the financial performance. Limited users may be issued a forecast or a single projection.

A complete prospective financial statement includes, at a minimum, the items listed in Exhibit 2. While a condensed version is acceptable, prospective financial statements should preferably be in the format of historical financial statements. A presentation that omits one or more of the first nine items is considered a partial presentation inappropriate for general use. If items ten, eleven or twelve are missing, the document is considered deficient in presentation and the external reviewer will note this in the accountant's report.

Earlier literature rejected the idea that a prospective financial statement could contain a range of dollars for each line item in the report. Only specific monetary amounts were allowed. The AICPA relaxed this restriction and now permits ranges as well as point estimates. They caution, however, that when a range is selected, it should not bias or mislead the reader, such as, a range in which one end is significantly less expected than the other.

Reporting Rules

For a long time, the AICPA was under pressure from CPAs to establish standards for accountants who review, compile or assemble prospective financial statements. The first document that provided procedures and mandated reports focused solely on reviewing financial forecasts. While it was a start, it fell short of the needs of public and management accountants who needed guidance on providing other services as well as issuing projections. In addition, the significance of the term "review" of a financial forecast was confusing to many readers who understood the level of assurance given to a review of an historical financial statement. To correct for these deficiencies, in 1983 the AICPA issued an exposure draft and in 1986, after much discussion and some modifications, published the Guide for Prospective Financial Statements. The Auditing Standards Board approved the Guide and established procedures and reporting standards for the accountant who either (1) submits to his or her clients or others prospective financial statements that he or she has assembled or assisted in assembling or (2) reports on prospective financial statements that were compiled, examined or in which agreed-upon procedures were applied, if those statements are, or

EXHIBIT 1
Summary Of Guidelines For Prospective Financial Statements

1. Financial forecasts should be prepared in good faith.
2. Financial forecasts should be prepared with appropriate care by qualified personnel.
3. Financial forecasts should be prepared using appropriate accounting principles.
4. The process used to develop financial forecasts should provide for seeking out the best information that is reasonably available at the time.
5. The information used in preparing financial forecasts should be consistent with the plans of the entity.
6. Key factors should be identified as a basis for assumptions.
7. Assumptions used in preparing financial forecasts should be appropriate.
8. The process used to develop financial forecasts should provide the means to determine the relative effect of variations in the major underlying assumptions.
9. The process used to develop financial forecasts should provide adequate documentation of both the financial forecasts and the process used to develop them.
10. The process used to develop financial forecasts should include, where appropriate, the regular comparison of the financial forecasts with attained results.
11. The process used to prepare financial forecasts should include adequate review and approval by the responsible party at the appropriate levels of authority.

Source: *Guide for Prospective Financial Statements,* AICPA, 1986, pg. 22-23

EXHIBIT 2
Minimum Presentation Guidelines For Prospective Financial Statements

1. Sales or gross revenues
2. Gross profit or cost of sales
3. Unusual or infrequently occurring items
4. Provision for income taxes
5. Discontinued operations or extraordinary items
6. Income from continuing operations
7. Net income
8. Primary and fully diluted earnings per share
9. Significant changes in financial position
10. A description of what management intends the prospective financial statements to present, a statement that the assumptions are based on information about circumstances and conditions existing at the time the prospective information was prepared, and a caveat that the prospective results may not be achieved
11. Summary of significant assumptions
12. Summary of significant accounting policies

Source: *Guide for Prospective Financial Statements,* AICPA, 1986, pg. 35

Two levels of service exist for prospective statements: compilation and examination.

EXHIBIT 3
Standard Compilation Report of a Forecast
(Does not contain a range)

We have compiled the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year ending, in accordance with standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of a forecast information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Source: *Statement on Standards for Accountants Services on Prospective Financial Information,* AICPA, October, 1985, pg. 9-10

EXHIBIT 4
Standard Report on an Examination of a Forecast
(Does not contain a range)

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. Our examination was made in accordance with standards for an examination of a forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.

In our opinion, the accompanying forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Source: *Statement on Standards for Accountants Services on Prospective Financial Information,* AICPA, October, 1985, pg. 15

reasonably might be, expected to be used by another party. The Auditing Standards Board Statement is effective for engagements in which the date of completion is September 30, 1986 or later.

New Levels of Service

For prospective financial statements, two levels of service now exist: compilation and examination. (The word "examination" has been substituted for the term "review" to eliminate confusion between prospective and historical financial statements).

A compilation is a professional service that involves (a) assembling, to the extent necessary, the prospective financial statements based on the responsible party's assumptions, (b) performing the required compilation procedures, and (c) issuing a compilation report. While a compilation is not intended to provide assurance on the prospective financial statement, it is clearly more than putting prospective numbers in the form of a financial statement. The accountant must be familiar with the industry, read the statements and the summaries of significant assumptions and determine that the presentation and disclosures are in conformity with AICPA guidelines. The report for a forecast will follow the standard compilation report form shown in Exhibit 3. The wording is modified for a projection or for prospective financial statements that contain a range instead of single monetary amounts.

An examination is a professional service that involves (a) evaluating the preparation of the prospective financial statements, (b) evaluating the support underlying the assumptions, (c) evaluating the presentation of the prospective financial statements for conformity with AICPA presentation guidelines and (d) issuing a report. The procedures are more extensive than those of a compilation. The objective of the examination is to gather sufficient evidence to support the reasonableness of the assumptions and the appropriateness and completeness of the disclosures. The standard report for an examination of a forecast that does not contain a range is presented in Exhibit 4.

In addition to compilation and examinations, an accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements. To perform this service, it is necessary that the specified users involved have participated in establishing the nature and scope of the engagement, taken responsibility for the adequacy of the procedures performed, been assured the report is restricted to the specified users and the prospective financial statements include a summary of significant assumptions. At the conclusion of this type of engagement, a report must be issued.

Suggestions for internal use only reports are found in the Guide. (The Auditing Standards Board felt this was outside their area of responsibility but cautioned the accountant to follow all rules of ethical conduct.) The procedures should be consistent with the nature of the engagement, and a written understanding should be established with the client regarding the services to be performed and the restriction on the distribution of the prospective financial statement. A report should be issued identifying the statements being reported on, describing the character of the work performed and the degree of responsibility the accountant is taking, and indicating the restrictions as to the distribution of the document and report.

Implications for Public Accountants

The new levels of service and the new definitions provide challenges to the profession:

- Become familiar with the Auditing Standard Board's *Statement on Standards for Accountants' Services on Prospective Financial Information* (October, 1985) and the *Guide for Prospective Financial Statements* (1986).
- Clarify the differences between a forecast and a projection, as well as the differences between a compilation and an examination, with all users: management, bankers, stockholders, potential buyers. Just as confusion existed for a short time over compilation and review of historic financial statements, expect a learning period.
- Determine who in your firm has the expertise to perform compilations and examinations and who will review the work.
- Establish a data base of common economic and industry indicators useful for making predictions.
- Learn how to forecast using spreadsheets.
- Improve your forecasting techniques by integrating statistical analysis in your forecasts and projections.

Implications for Management Accountants

The burden of preparing prospective financial statements rests with management. Management accountants must:

- Be sure the forecast is prepared in good faith. Good faith in this context includes making a diligent effort to develop appropriate assumptions. Optimism and pessimism should be avoided.
- Be sure marketing, operations, finance and other technical personnel provide input to the forecast.
- Acquire the appropriate analytical skills to engage in forecasting.
- Develop a model so that variations in assumptions can be measured.
- Use the same accounting principles in the forecast and the historic financial statements.
- Develop a data base of useful external information.
- Keep track of key internal and external assumptions. Some will become more important over time while others will become less important.
- Maintain records so that the forecast can be compared to actual results.
- Be sure there is adequate review and approval at appropriate levels of authority.

The Future

Forecasts and projections have always been important to managers, creditors, stockholders, and potential buyers. Accountants know there is a need to refine, improve and standardize the services relating to prospective financial statements. By following the AICPA guidelines, readers will be more informed, understand the tentative nature of prospective financial information, and appreciate the accountant's role in compiling or examining the statements. Undoubtedly, the rules will be subject to constant change and interpretation, just as historical financial statements have evolved over time; however, the improved communications between accountant and user will justify the effort and the profession will be enhanced by the informed use of prospective financial information.Ω

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Anne J. Rich, Ph.D., CPA, CMA, *is chairperson, Department of Accounting, and Director, Executive MBA Program, both at the University of Hartford, Connecticut. She is a business consultant with emphasis on systems analysis and financing packages and is a member of the AICPA, Connecticut Society of CPAs, NAA and AAA.*