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Reporting on Forecasts, Before the 85th Annual Meeting of the American Institute of Certified Public Accountants, October 3, 1972, Denver, Colorado

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I predict that the SEC will soon require that forecasts be included in prospectuses. It appears that influential members of the staff and, perhaps, some of the Commissioners are now convinced that historically-oriented financial statements are not sufficient to help investors make investment decisions. There is an awareness that forecasts prepared by analysts are not equally available to all investors and that such forecasts are not necessarily correlated with what company managements think of their own future. Since estimating future earnings and the multiple to be applied is the name of the game for investors, it is only surprising that the SEC has taken so long to begin to reevaluate their traditional antiforecast position.

There is no doubt that when forecasts first appear they will be accorded greater validity than they deserve by some unsophisticated investors. Some management-prepared forecasts will not be as good as those prepared by some analysts who have a better appreciation of relevant industry and economic factors. Some managements will put too much conservatism in their numbers in an attempt to protect themselves, and a few may use forecasts to manipulate the market. There will be some instances where companies suffer competitive damage because of the need to disclose corporate plans. All of these arguments are valid but seem not persuasive enough to continue the proscription against the public dissemination of forecasts.

The biggest problem that must be faced is that of reliability. I believe that forecasts should be published only in those circumstances where a reasonable degree of reliability can be expected and, unfortunately, the SEC does not seem to be as impressed as they should be with this problem. Amendments to SEC forms presently under consideration would ask a new high risk company to disclose its plan of operation for as much as one year ahead. While not strictly a forecast, the budget information given would include anticipated resources in addition to cash expenditures expected to be incurred. To the extent that such future resources include anticipated operating revenues, such estimates will likely be unreliable. Identifying such an estimate as a management's plan helps somewhat, but since most of the estimates of future operating revenues for hot issue companies are likely to miss by a wide margin, I fear more investors will be hurt than are helped. Hopefully, as the SEC moves into requiring forecasts and learns more about the problems, they will also prescribe definite limitations which will preclude forecasts or elements of forecasts which are likely to be unreliable.

I think that it is possible, but not probable, that the SEC will require examination of forecasts by CPA's. I think that we will have an opportunity to refuse to become involved. The SEC recognizes that, although CPA's are involved in estimates of recoverability and collectibility and related matters in reporting on historical financial statements, the estimates inherent in forecasts push further and more explicitly into the future. There is also recognition that attesting to historical financial statements is quite different and there is an understanding of the need not to discredit the CPA's opinion on historical financial statements. The SEC has also indicated an appreciation of the possibility that other groups, rather than CPA's, could be utilized in the preparation or review of forecasts. There has been the suggestion by others that a forecast should be expressed as a range with probabilities and that this would put accuracy in a framework which might reduce the need for any third party review of forecasts. Some CPA's and management consultants have announced that they are in the forecasting business and have stated in SEC hearings that the ordinary CPA does not have the competence for forecasts. All of these factors notwithstanding, I think that after some relatively brief experience without any third party involvement that the SEC will come to the conclusion that our profession should be put to work to increase the reliability of published forecasts because the CPA's objectivity and accounting and auditing skills can be effective in increasing the reliability of some types of forecasts.

But, we should not sit and wait for an SEC proposal to involve us on their terms, then - as has happened before - go into a crash study program and try to modify their proposal. I personally think we should be involved in forecasts because as they come into use the importance of historical financial statements will be somewhat less and financial reporting will become a broader function. The public will not be served by an unwillingness on our part to supply our expertise. But I think that we should be involved only on the terms we think are reasonable. I think the best way to accomplish that is to take the initiative. I believe that my colleagues on the Committee on Auditing Procedure agree to act rather than react, to lead rather than respond. I am hopeful that we can develop a sound approach for the CPA's involvement with forecasts and take it to the SEC.

Our Committee on Auditing Procedure project was undertaken before current SEC interest in forecasts became apparent. We became concerned with CPA feasibility studies made available to the general public in connection with the sale of revenue bonds. The profession was and is split on whether or not CPA's should issue reports to the general public on this type of forecast. Our initial research concentrated on these feasibility studies and also on the nonpublic forecasts which CPA's have been preparing for clients and clients' bankers for years. About the time the SEC began to show signs of changing their traditional antiforecast posture, we undertook a research study of practice in the United Kingdom where there exists a substantial body of experience with public reporting on forecasts. Our research project was directed by Doug Carmichael, and his full report will be published in the January Journal of Accountancy.

This is basically what our research study revealed. Forecasts appear in the U.K. in both prospectuses and in some circulars issued in take-overs and mergers. Although on both these occasions chartered accountants make similar forecast reviews, they only issue reports in take-overs and mergers. When they are involved with prospectuses, they use the withholding of their consent to prevent unsatisfactory forecasts. Chartered accountants' reports on forecasts understate the nature of their examination, stating only that the accountant has reviewed the accounting bases and calculations of the profit forecast and that the forecast, insofar as the accounting bases and calculations are concerned, has been properly compiled on the basis of the stated assumptions and, further, that the forecast is presented on a basis consistent with the accounting principles used in the historical financial statements. In actual fact, however, their examination of the forecast extends beyond merely compilation and accounting principles and includes a review of the assumptions on which the forecast is based. An understanding exists in the financial community that chartered accountants would not publicly report on a forecast without qualification unless they had satisfied themselves about the assumptions on which the forecast was based.

Chartered accountants who we interviewed told us that they were initially quite reluctant to report publicly on forecasts when the statutory requirement was imposed on them some three years ago, but that now they would be quite willing to report even without the statutory requirement. In fact, we are beginning to see some chartered accountants' reports in prospectuses where there is no statutory requirement for accountants' reports.

More importantly, about 75% of the U.K. accountants interviewed said they now would be willing to report publicly concerning the assumptions if asked to do so. Many of these said that they would be willing to report on whether management had developed the assumptions with due care and consideration. This type of conclusion appears to be consistent with the character of the chartered accountants' examination of assumptions and the traditional capabilities of an accountant. Reporting on due care and consideration seems more appropriate than trying to say something about the reasonableness of assumptions. Forecasting involves subjective judgments, and determining the reasonableness of assumptions would place the accountant directly in management's shoes. Saying something about the forecasting process - the due care and consideration given rather than the reasonableness of assumptions - is something more in keeping with an accountant's function. In this respect, U.K. accountants' forecast work programs placed major emphasis on the study of the forecasting system and reliance on past forecasting success of the company. With this emphasis on the forecasting process, MS skills become less important. We were told by U.K. accountants that they would employ people with MS skills only if the forecast involved a substantial change in operations and, even then, not all accountants saw the need for MS skills. Generally, the critical skills which our English cousins felt were necessary to appraise due care and consideration were good business judgment, the ability to marshal quantities of data and the related skills of measuring, comparing and evaluating financial information.

U.K. accountants do not believe that their independence suffers when they also serve as auditors of historical financial statements for the same client. They believe that the pressures on them to hit the forecast do not differ significantly from the pressure which results from management's desire to achieve acceptable operating results when forecasts are not published. But, an important reason for this is the professional requirement that management accept the assumptions on which the forecast was based as theirs regardless of the participation of the accountant in their development. U.K. accountants achieve this through written acknowledgment from management and wording in the accountants' report to the effect that the Directors are solely responsible for the forecast. This is not to say that there is no concern about objectivity. We noted some instances where such concern resulted in the use of different supervisory personnel in the forecast review and in the following audit of historical financial statements. Merchant bankers in some situations require that different people conduct the forecast review, although it is not clear whether this results from concerns with independence or merely a desire to use people on the forecast review in which the bankers have most confidence.

The accuracy of published forecasts in the United Kingdom has been satisfactory - in most instances, within plus or minus 10% of the forecast profit. Most of the forecast failures - those which varied more than 10% - were satisfactorily explained. Litigation to date has been negligible. However, these good results are in large measure the result of not going very far into the future - eighteen months is the maximum forecast period, with shorter periods being used in less than ideal situations. It is also the result of forecasting only established businesses - new ventures do not have shares held by the public and, therefore, forecasts are for companies with established track records. It is also the result of limiting forecasting to situations where the company has a good past record of forecasting success and a forecasting system. Chartered accountants, in conjunction with merchant bankers, will delay a security offering until a forecasting system has been established and checked out.

It is obvious that the British experience is not directly transferable to the U.S. We do have hot issues. We do have a much greater propensity to litigate, and we have a 1933 Securities Act with heavy burdens for companies and their experts. We don't have a substantial history of forecasting experience, and our investors are not used to seeing forecasts.

Nevertheless, an understanding of the British experience, with an appreciation of the differences in the social, economic and legal environments, has helped our forecasting subcommittee to draft a Statement on Auditing Procedure for consideration by the full Committee on Auditing Procedure at its November meeting. Incidentally, our subcommittee includes two Management Services representatives. The subject of forecasting does not full exclusively into the Auditing sphere, and Management Services people have had some substantial experience in preparing feasibility studies and similar types of forecasts.

The major questions faced by our subcommittee were: On what terms can we associate with forecasts and still preserve the credibility of our profession? What competence is required to perform a meaningful review function? How should we operate to avoid independence problems which may result from also being the auditor of historical financial statements? How do we limit legal liability to the extent that we can live with it? All these questions are closely interrelated.

It is essential that the CPA not lose his position as a credible witness to the fairness of historical financial statements by virtue of association with forecasts. In order to preserve the CPA's credibility, I believe that it is essential that forecasts be clearly differentiated from historical financial statements and that the CPA's report on forecasts clearly define his role and the limitations of his responsibility. It is also important that the CPA avoid association with those forecasts which may be expected to be unreliable. More on that important point later. I believe that forecasts should never appear side by side with historical financial statements, and a condensed format that makes them look different is preferable. Also, the assumptions on which the forecast is dependent should be prominently displayed and tied in with the forecast. The CPA's report on a forecast should be separate from his report on historical financial statements. It should deny an opinion on whether the forecast will approximate future results, picking up the present ethics rule. It should also differentiate between those aspects of the forecast which the CPA can expertize, namely the use of accounting principles and the compilation of the forecast from the stated assumptions, and those areas of the forecast where the CPA can only perform limited procedures, namely those relating to the choice of the underlying assumptions.

CPA's are not competent to develop assumptions. The fact that the CPA does not have any ability to make the assumptions come true alone should disqualify him. In addition, the special management skills which might be required to develop assumptions would preclude involvement by most members of the profession. Although CPA's should not and cannot develop assumptions, experience in the U.K. indicates that the objectivity of independent accountants, combined with their accounting and auditing skills, can contribute significantly to the selection of good assumptions by management. If we adopt the U.K. approach, and I recommend that we do, then CPA's reports on forecasts should indicate that the procedures applied with respect to assumptions were those which accountants might reasonably employ and that these procedures were chosen in order to appraise the care and consideration given to the selection of assumptions by management.

Reporting on the care and consideration given to the selection of assumptions by management seems to be a reasonable burden for CPA's to carry if we can develop guidance material on procedures which accountants should employ and if the forecast situations are those where CPA skills can be usefully applied. For this reason and also collaterally to help cope with the credibility problem, I believe our professional literature should proscribe public association with forecasts for new ventures - that is, companies without a past history of operations, with forecasts that extend too far forward in time - and here the maximum period should normally be eighteen months, and with forecasts made by companies with a poor record of forecasting success that have not significantly altered their forecasting system so that success can be expected or by companies totally lacking in a forecasting system.

Forecasts developed under a forecasting system should reduce the degree of subjectivity involved in preparing them and formalize the thought process of management. Making the care and consideration appraisal under these circumstances will still tax the accountant's business judgment but, I think, not unreasonably. Many accountants will be unhappy about making judgments without specific ground rules. We can help if we can describe the elements of an effective forecasting system and the procedures normally employed to review that system. Experience in the U.K. should be helpful in this respect. But, let there be no doubt - if we undertake to appraise the care and consideration given by management to the selection of assumptions, even with the proscriptions and requirements I have mentioned, we are extending our traditional scope of practice.

The arbitrary proscriptions on involvement with public forecasts, made on the basis of the limited general competence of CPA's and concern with CPA credibility with the public, is probably not necessary in nonpublic forecasts. These arbitrary restraints are not necessary to control association with forecasts for named third parties, provided the CPA's report to such persons - who might be bankers or sophisticated investors - is limited to their use and provided that CPA's use good sense in what they undertake to do and how they word their reports. Reports for sophisticated third parties are frequently issued today and I believe serve a valid business purpose.

The limitations on public reporting would operate today to eliminate many CPA reports on hospital bond offerings since many of them are for hospitals before there is any management on the scene or are for new hospitals, and many extend five years into the future and are not the product of a forecasting system. However, I am not convinced that the hospital part of our economy would be unduly hampered by this position by our profession. Perhaps those hospitals which would be cut off from public funds should not be raising money from the general public on the basis of forecasts.

The question of CPA independence has been raised strongly by a prominent member of our profession. His position is that association with forecasts will destroy the most essential ingredient of the CPA - his independence - because the CPA would not be uncommitted when he looked at what the actual results finally turn out to be. This accountant has stated that if it is concluded that independent accountants can give supporting opinions endorsing the reasonableness of assumptions underlying management forecasts, then such accountants should thereby be disqualified from giving an opinion on the financial statements for the period covered by the forecast. However, indications from the United Kingdom are that an accountant can retain his independence when operating as a reporter both on forecasts and on following historical financial statements. The independence question would be of greater concern to me if we were proposing that CPA's endorse the reasonableness of assumptions. As mentioned previously, our subcommittee proposes that management undertake sole responsibility for the assumptions used and that the CPA not report on reasonableness, but rather on the care and consideration with which management has developed the assumptions.

I am much less concerned about the likelihood of real loss of independence than I am about the appearance of loss of independence. In this respect, we will have to rely on professional literature and a clearly worded public report stating management's responsibility for assumptions and the nature of our work with respect to their responsibility.

The biggest question mark in dealing with forecasts is legal liability. I believe that we should be able to live with legal liability for forecasts not subject to the 1933 Act. If our professional literature and report are clear with respect to the competence that we purport to have and the responsibilities we take, then we should be judged only on the care with which we apply the procedures indicated by our statement of competence. I do not imply that we can dismiss the problem of legal liability in non-1933 Act filings. Forecasts are going to be more important to investor decisions than historical financial statements, and there will be more occasions where forecasts are materially different than the facts, so that the profession can expect more lawsuits as a result of being involved with forecasts. Successful defense of lawsuits is a major cost to a CPA firm, both in terms of legal fees and in terms of the drain on the energies of senior people in the firm. However, if forecasts are the future and we have capabilities with respect to them needed by the economy, we will have to shoulder the burden. We cannot expect to maintain the stature of our profession if we refuse to become involved with forecasts at a time when the importance to investors of historical financial statements is downgraded. And, by the way fellow professionals, the economic rewards of being in this profession relate directly to the importance of the role we play in the business community and in the economy.

Our biggest legal liability problem may be the Securities Act of 1933. I say "may be" because there is an opinion which holds that a forecast is an opinion for securities law purposes and, therefore, does not bring on the Section 11 liability which is activated by a material misstatement or omission of fact. AICPA legal counsel has not yet opined on this question, but our Committee is proceeding on the assumption that under existing legislation a CPA would be required to assume the responsibilities of an expert for a forecast which he reported on in a prospectus. While the CPA's competence as an accountant qualifies him as an expert in the compilation of a forecast and the treatment of projected transactions in conformity with generally accepted accounting principles, we cannot expertize the underlying assumptions of a forecast. Consequently, if the circumstances of association with a forecast under the 1933 Act are such that the CPA cannot assume differing degrees of responsibility for the various components of the forecast, we cannot be associated with forecasts in 1933 Act filings. It would appear that we should not be associated with forecasts under the 1933 Act until there is legislation amending the Act or a clear statement by the SEC that the extra liabilities do not apply and our counsel agrees that the courts will concur. I think this initial position by the profession is a necessary one and, in addition, may be a key to some reconsideration of all the onerous CPA liabilities under the 1933 Act. If the Committee on Auditing Procedure can reach conclusions on the questions I have raised concerning the CPA's involvement with forecasts, then I believe we should take the extraordinary step of opening discussions with the SEC on the subject of forecasts and negotiate with them on a proper involvement of the CPA. I think we have more to gain by taking the initiative than by waiting for the SEC to move and then reacting to it.

If we resolve the questions I have posed in the way that I have suggested, then the CPA's report will describe the forecast and the scope of his study, express a professional opinion on the compilation of the forecast and the accounting principles employed, conclude as to whether management has developed the assumptions with appropriate care and consideration, and deny an opinion as to whether the projected statement may approximate actual future results. This is the accountants' report on a forecast as I presently see it:

> "We have studied the projected statement of operations of the XYZ Company for the year ended December 31, 1972. Our study was conducted in accordance with applicable standards published by the AICPA. We have performed such tests and procedures with respect to the compilation of the forecast from the stated assumptions as we considered necessary in the circumstances. However, assumptions as to future events must remain the sole responsibility of management. Our procedures with respect thereto were generally limited to those which accountants might reasonably employ and were chosen to appraise the care and consideration given to the selection of assumptions by management.
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> In our opinion, the projected statement of operations gives effect in all material respects to the assumptions described on the basis of the accounting principles regularly employed by the Company.
>
> We believe that management has chosen the assumptions with due care and consideration. However, we express no opinion as to whether the projected statement may approximate actual future results."

I have described the status of forecasting at the present time from the viewpoint of a member of the Committee on Auditing Procedure. It will continue to be a hot topic as the SEC and other interested groups continue their deliberations. The Trueblood report should provide stimulus. I predict that we will be in the forecasting business within the next year, and I hope that you will have a pronouncement from the Committee on Auditing Procedure for guidance.