FINANCIAL FORECASTS AND ACCOUNTING: AN ANALYSIS OF THE BASIC ISSUES

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In its attempt to better serve the economic community and in particular the users of financial statements, accounting has, throughout the years, adopted new or improved methods of financial accounting and reporting. In addition to that, accounting has also enlarged its scope of financial accounting and reporting by adding new areas in the sphere of its interest. While that enlargement of the scope has been beneficial to the investing public, recent years have, however, witnessed a significant increase in the demand for the publication of more and better accounting information.

With respect to how accounting can be expanded, the American Accounting Association has indicated that the "... accouning discipline could be expanded, either by absorbing additional measurement methods into the discipline or by broadening the concept of activities upon which it reports." [1]

Several areas have been the focus of attention, and new ones are being considered. One area which has attracted considerable attention is the area of disclosure of corporate expectations through the publication of financial forecasts.

Many academicians, practitioners, and professional organizations advocate the publication of forecast data on the grounds that forecasts are useful in making investment decisions. There are, however, those who oppose

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1. American Accounting Association, Committee to Prepare a Statement of Basic Accounting Theory, A Statement of Basic Accounting Theory, AAA, 1966, p. 64.

the publication of forecasts and present arguments which question the benefits of published forecasts.

The importance and complexity of the issues surrounding the publication of corporate forecasts are apparent in the Study Group on the Objectives of Financial Statements' cautious recommendation of the inclusion of forecasts in financial statements:

> Forecasting is clearly an integral part of every economic decision.... Publication of explicit forecasts of enterprise activities may well fit the objectives of financial statements. They may make financial statements more comprehensive and useful ; but, the uncertainty inherent in forecasting may diminish the usefulness of the information. [2]

The purpose of this study is to discuss the most important issues associated with the disclosure of management financial forecasts. The study consists of the following four parts :

1. Background.
2. Arguments for and against the publication of financial forecasts.
3. Authoritative bodies, professional organizations and financial forecasts.
4. Conclusions.[3]

BACKGROUND

According to Cooper, Dopuch, and Keller, a proposal to disclose forecasts was first introduced in the accounting literature in 1947 by Stuart A. Rice at the annual meeting of the American Institute of Certified Public Accountants. Dr. Rice, then Director of the Division of Statistical Standards, U.S. Bureau of the Budget, said :

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2. American Institute of Certified Public Accountants, Report of the Study Group on the Objectives of Financial Statements, *Objectives of Financial Statements*. New York: AICPA, October 1973, p. 46.

3. The presentation here is based on the U.S.'s literature and experience, but the issue of financial forecasts concerns other developed countries too. See D. R. Carmichael, «Reporting on Forecasts: A U.K. Perspective,» *Journal of Accountancy*, January 1973, pp. 36-47, and Institute of Chartered Accountants in England and Wales, *Accountants' Report on Profit Forecasts*, Institute of Chartered Accountants in England and Wales, 1969, for details of the experience in Great Britain.

In the government it is the custom to publish budgets but not the final result of operations. In private accounting the custom is the reverse, I should like to see business firms undertake to publish their budgets as well as financial statements because (1) it will give valuable information to stockholders and enable them to judge the planning ability of their managers and (2) provide valuable information on business plans and business operations.... for economists and statisticians. [4]

More than a decade later, this idea started to attract further attention and a number of articles appeared in the accounting literature. Some examples are Nielsen, [5] Bevis, [6] Schattke, [7] Birnberg and Dopuch, [8] Solomon, [9] Wilkinson and Doney, [10] Ijiri, [11] Reiling and Burton, [12] and Burton. [13]

In 1960 Neilsen observed :

With the increased emphasis on prediction and planning with regard to business activity ...,it is to be expected that the nature of future accounting needs to change if the accounting function is to survive as an important element of modern business .... Therefore, it is evident that the orientation of accounting will have to be more toward the fu-

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4. As quoted in W. W. Cooper, N. Dopuch, and T. F. Keller, «Budgetary Disclosure and Other Suggestions for Improving Accounting Reports,» *Accounting Review*, October 1968, pp. 640-648.

5. Oswald Nielsen, «New Challenges in Accounting,» *Accounting Review*, October 1960, pp. 583-589.

6. Herman W. Bevis, «The CPA's Attest Function in Modern Society,» *Journal of Accountancy*, February 1962, pp. 28-35.

7. Rudy Schattke, «Expected Income-A Reporting Challenge,» *Accounting Review*, October 1962, pp. 670-676.

8. Jacob G. Birnberg and N. Dopuch, «A Conceptual Approach to the Framework for Disclosure,» *Journal of Accountancy*, February 1963, pp. 56-63.

9. Ezra Solomon, «Accounting in the Next Decade,» *Journal of Accountancy*, January 1965, pp. 22-26.

10. James R. Wilkinson and Lloyd D. Doney, «Extending Audit and Reporting Boundaries,» *Accounting Review*, October 1965, pp. 753-756.

11. Yuji Ijiri, «On Budgeting Principles and Budget-Auditing Standards,» *Accounting Review*, October 1968, pp. 662-667.

12. Henry B. Reiling and John C. Burton, «Financial Statements: Signposts As Well As Milestones,» *Harvard Business Review*, November-December 1972, pp. 45-54.

13. John C. Burton, «Forecasts: A Changing View from the Securities and Exchange Commission,» in P. Prakash and A. Rappaport (eds.), *Public Reporting of Corporate Financial Forecasts*, Commerce Clearing House, 1974, pp. 81-98.

ture events of business and only have reference to past events when such information is useful for either corrective action or for formulating still further plans for continued future actions. [14]

Birnberg and Dopuch proposed a new framework of disclosure which included a section on management's expectations. The authors' opinion on this point was expressed as follows :

> In order to inform the external parties of what they anticipate the future to hold for the entity, management must provide the investor with information on three types of expectations.
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> 1. Prospects for the economy.
> 2. Prospects for the industry and the enterprise as a member of that subset.
> 3. The specific expectations which underlie the major investments made in resources and the projects undertaken in attempting to achieve the enterprise's goals. [15]

Though there are those who favor publication of financial forecasts, there are those who question the benefits of published forecasts. In a rather provocative article, Kapnick of Arthur Andersen and Company came out strongly against publication. [16] He believed that, while financial statements should help the investor in appraising the future, any interpretations of prospects are the responsibility of the investor.

Kapnick maintained, however, that much could be done to improve the financial information already being made available to investors and the public. He suggested that historical financial statements must be more meaningful, understandable, and relevant than they are now. In addition, management should provide the public with information concerning management's goals, assumptions, and factual knowledge about the future. This kind of information, however, is far different from management's publishing forecasts of sales, net income, and earnings per share for the next year. [17] The suggested improvements "can be of substantial assistance to

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14. Neilsen, pp. 584-585.

15. Birnberg and Dopuch, p. 58.

16. Harvey E. Kapnick, «Will Financial Forecasts Really Help Investors?» *Financial Executive*, August 1972, pp. 50-54.

17. Ibid., p. 50-52.

the public investor in assessing the future and in his determination of tne risks he is willing to assume with respect to a particular business enterprise." [18]

Financial forecasts were frequently made available outside the firm. These forecasts were taken many forms, ranging from formally prepared and published earnings forecasts to (a) speeches to security analysts, (b) press releases, and (c) informing analysts that their forecasts are "in the ball park". For tne most part, these types of forecasts had two elements in common : they were unregulated by the SEC and, except for publicly issued forecasts, they were discriminatory in that they were supplied by management to selected persons and not publicly disclosed.

In a study by the National Association of Accountants, it was disclosed that, of the companies surveyed, approximately 33 percent provided the public with an indication of profit forecasts. [19] However, the information was generally disseminated through press releases or at talks at analysts' society meetings rather than directly to stockholders. Approximately 40 percent did not disclose profit, but were willing to comment on whether an analyst's forecast was "in the ball park".

ARGUMENTS FOR AND AGAINST THE PUBLICATION OF FINANCIAL FORECASTS

The accounting and financial literature, reflecting the increasing concern and interest of the financial community, prompted the Securities and Exchange Commission in 1972 to reexamine its position of prohibiting the inclusion of projections and forecasts in documents filed with it. More specifically, the decision of the SEC to reconsider its historical position on forecasts was mainly based on the following factors : [20]

1. There was an increasing recognition of the relevance of future-oriented data in investment decisions. It became apparent that securities were being traded primarily on the basis of expectations. While such expectations could be developed in part from the historical financial record of a firm, it became difficult to justify a position that information about the firm's future expectations should be denied to investors as a matter of policy.

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18. Ibid., p. 54.

19. For a summary of the study's findings, see Morton Backer, «Reporting Profit Expectations,» *Management Accounting*, February 1972, pp. 33-37.

20. John C. Burton, pp. 84-86.

2. The process of forecasting had been better defined and the reliability level had been increased primarily through improvement in management sophistication in working with budgets and forecasts. The result was that a number of firms were ready to disclose their forecasts publicly.

3. There was increasing evidence of discriminatory disclosure of forecast data by corporate management.

In order to gather additional information relevant to a reassessment of its policies relating to disclosure of projected sales and earnings, the Commission held public hearings from November 20 to December 12, 1972. The hearings primarily addressed two questions: (1) Should forecasts be published under SEC supervision ? and (2) If forecasts are to be published, should they be verified be an independent third party ?

Testimony was given by many corporate executives, security analysts, investment bankers, certified public accountants, lawyers, and other interested parties. As to be expected with such controversial issues, there was a wide diversity of views. Testimony, however, concerning whether forecasts should be published under SEC supervision was overwhelmingly in favor of publication.

Edwards and Warren have reported the major arguments for and against the reporting of forecasts which surfaced in the SEC hearings. [21] Since these arguments constitute a representative summary of the views presented in the accounting and financial literature, they are presented in Table 1.

Following these hearings, the SEC made an announcement in which it stated that it would permit companies under its jurisdiction to dislcose forecasts, on a "voluntary" basis, when certain conditions are met. This announcement and subsequent ones made by the SEC are discussed later under the SEC's position.

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21. James D. Edwards and Carl S. Warren, «Management Forecasts: The SEC and Financial Executives,» MSU Business Topics, Winter 1974, pp. 51-55.

TABLE 1

ARGUMENTS FOR AND AGAINST THE PUBLISHING OF FORECASTS

For

Forecasting of future earnings is an essential part of the investment decision.

We must assume that investors can make informed investment decisions if they are given appropriate facts.

It is in the public's interest to have relevant information available.

The purpose of the Securities and Exchange Act of 1933 was to provide all information necessary to the exercise of an informed investment decision.

Forecasts appear regularly in the newspapers and we don't know what standards are used: when forecasts are wrong the public can't determine why.

Management is better qualified than an outside user of the data to create a complete forecast.

The SEC, by requiring and regulating forecasts, will improve the quality of information.

Appropriate SEC quidelines would reduce the number of deliberately misleading forecasts by establishing formal management accountability for such issuances.

If forecasting is required, a major inequity in the flow of information to investors will be corrected.

The basic philosophy should be to give everybody all the relevant information and let each make his own choice as to the investment merits of the investment opportunity and as to the significance of the information.

The statement of the assumptions which underlie a forecast is a good way of making available to investors an idea of the risks which they are taking.

Forecasts will assist in maintaining an orderly market.

Forecasting can be done under our present legal system.

A controlled and more orderly process of preparing projections and earnings forecasts will increase corporate responsibility and investor confidence.

The benefits derived by forecasting corporation earnings will be greater than the costs.

Publication of forecasts could eliminate the possible prejudicial practice of releasing earnings projections to analysts without simultaneous release to stockholders.

TABLE 1 (Continued)

Against

The liability of issuers of forecasts must be clarified and limited.

The present open-ended liability might cause management to hedge all projections' rendering them useless.

Average investors will give unwarranted credibility to a formal forecast. This would erode investor confidence in all financial data.

Management may tend to concentrate its efforts on making previous forecasts come true, that is, management would be under pressure to realize forecasts previously made.

Many companies don't prepare adequate documentation.

Forecasting is impossible for start-up companies.

Investment decisions are based on more than earnings numbers: the quality of earnings is important.

The current system is serving the investor well.

Management should not have to make forecasts--it is not trained to do so.

It would be unrealistic for companies to educate their shareholders as to the problems in forecasting.

Management cannot estimate earnings well enough to satisfy the man on the street.

For forecasts to have credibility they must be reviewed by an external third party and currently no such part is available. (CPA's do not have adequate forecasting audit standards).

Potential legal liability would force management to keep forecasts within judicially acceptable tolerances rather than what it believes is in the best interests of the company and shareholders.

We already have forecasts by those performing the investor functions.

The need for forecasts has not been demonstrated.

To forecast one year's earnings may well lull the investor into short-range comfort, he should be looking at a much longer period to evaluate his investment.

Attempts to establish an across-the-board criterion of reliability or standards of performance forecasting are impracticable.

You can't divide the attitude that a manager has as manager and his own investment position. Many chief executives have substantial stockholdings in their own company—they may be guided more by their stockholdings than by what may be good for the company.

Earnings projections have little value unless supported by a description of the under-

TABLE 1 (Continued)

lying assumptions, but disclosure of these assumptions could cause difficulties in sensitive matters. Disclosure of assumptions may: (1) divulge the corporate operating plan, (2) provide information which could restrict management's flexibility, (3) substantially increase internal operating costs, and (4) increase risk of antitrust litigations. (Disclosure of pertinent information by a company and its competitors could be considered equivalent to price fixing).

Misleading forecasts would be more of disadvantage to the market than no forecast at all.

Permission to use forecasts will give license to those who are unqualified or promotionally minded to abuse forecasting.

It is possible that issuance of forecasts will fuel the market speculative tendencies rather than contribute to sound investment.

Unless forecasts are continually updated, they will rapidly become outdated.

If forecasts are permitted, companies would only use them when it was to their best advantage.

Source: James Don Edwards and Carl S. Warren, «Management Forecasts: The SEC and Financial Executives,» *MSU Business Topics*, Winter 1974, p. 52.

AUTHORITATIVE BODIES, PROFESSIONAL ORGANIZATIONS AND FINANCIAL FORECASTS

The arguments for and against the publication of financial forecasts presented in the previous table offer a good illustration of the complexity surrounding the issue of financial forecasts.

This part of the study will discuss the positions taken by authoritative bodies and by the most important professional organizations on the issue of forecasts. In addition , it will analyze the contribution made by some of them in solving the many problems associated with that issue.

National Association of Accountants (NAA)

The position of the NAA was succinctly stated in December 1972 before the Securities and Exchange Commission.[22] The Committee on Management Accounting Practices, speaking for the NAA, reiterated its position previously put forth to the Study Group on Objectives.

The NAA believed that forecasts were desirable and encouraged their discretionary use at the option of management when the likelihood of misleading the reader is not great. The Association felt that since forecasts and projections were prevalent, there would be little conceptual justification for not including forecast data in financial reports. However, before requiring forecasts to be mandatory, the NAA felt that more research was necessary in certain areas. Those areas were :

1. Should the forecast be for revenues, expenses, cash flow, earnings per share, etc.? To minimize problems, the forecast of any of the preceding should be in terms of "trends" and "ranges".

2. The disclosure of the underlying assumptions is desirable. However, a difficulty is the possibility of disclosing information to competitors about new product development, marketing and pricing strategies, etc.

3. A reasonable time period to be covered by the forecast must be con-

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22. National Association of Accountants, «Statement to the Securities and Exchange Commission Regarding Forecasts,» in P. Prakash and A. Rappaport (eds.), *Public Reporting of Corporate Financial Forecasts*, Commerce Clearing House, 1974, pp. 265-268.

sidered. A longer period may be desirable, but the longer the period the greater the chance for inaccuracy. Criteria for developing an acceptable level of accuracy must be considered.

4. The frequency with which forecasts should be revised must also be considered. Frequent changes would be confusing, but changing circumstances would demand revision of the forecasts if they are to have any real value.[23]

The NAA pointed out that presenting forecasts could create the tendency to take actions contrary to the best interest of the firm in order to meet the forecasts.[24]

The forecasts should not be attested to by independent public accountants. The Association felt that attestation would be so limited, and the possibility of the user's misunderstanding so great, that attestation could lead to a greater loss of confidence than any offsetting increase in the reliability of forecasts.[25]

The Financial Analysts Federation (FAF)

The FAF took a position in favor of the publication of financial forecasts. The Federation made an extensive study of corporate forecasts, their dissemination, and their utility for investment decisions. In addition, it developed a system of continuous forecasting by public companies which was presented at the Public Hearings of the Securities and Exchange Commission.[26] From its research, the FAF arrived at three premises on which the proposal for systematic forecasting by public companies is based. These premises are :

1. Forecasts by management are a useful element in investment analysis and decision making for all corporate investments but primarily for equity type investments. They are regarded as important information, though not the sole imput to the process.

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23. Ibid., p. 266.

24. Ibid., p. 267.

25. Ibid., p. 268.

26. William S. Gray III, «Proposal for Systematic Disclosure of Corporate Forecasts,» *Financial Analysts Journal*, January-February 1973, pp. 64-71 and 85.

2. Forecast information in some form is voluntarily being made available by many companies. Arguments that companies cannot or should not make public forecasts are beside the point under these circumstances.

3. Dissemination of corporate forecasts is currently irregular and uneven. Fairness to all investors, actual and potential, requires more systematic disclosure by corporate management. [27]

The proposal for a continuous forecasting system included the following elememts :

1. Forecasting should be voluntary, not mandatory, at this time.

2. Once public forecasting has begun, forecast statements should be disclosed on a continuing basis.

3. Forecasts should be broadly disseminated on a regular basis.

4. The forecast period, for the present, should be the current and next fiscal year.

5. The forecast should be specific for sales, pretax earnings, net earnings and earnings per share.

6. Forecasts should be qualified by some expression of their tentative character.

7. Statement of assumptions on which the forecast is based.

8. Audit or certification of forecasts by independent experts should not be required. [28]

In addition, the FAF, responding to a request from the SEC, sponsored a research project to examine the desirability and possible content of a formal system of forecast disclosure. The findings of the research project were presented at the Public Hearings of the SEC. [29]

The project consisted of five separate studies :

1. A search of the published literature relating to corporate forecasting.

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27. Ibid., p. 66-67.
28. Ibid., pp. 67-69.
29. Samuel S. Stewart, Jr. «Research Report on Corporate Forecasts,» *Financial Analysts Journal*, January-February 1973 pp. 77-85.

2. An examination of corporate forecasts published in the *Wall Street Journal.*

3. An examination of the accuracy of forecasts made by financial analysts.

4. A questionnaire survey of selected members of the FAF to determine their opinions as to the desirability of a normal forecasting requirement.

5. An in-depth, personal interview survey of a smaller sample of FAF members.[30]

While some of the evidence gathered from the five studies was contradictory, six broadly supported conclusions emerged :

1. Many corporations currently generate forecasts. The accuracy of these forecasts is not impressive, particularly at turning points.

2. These forecasts are not widely available-that is, there is an uneven information flow. Some of the unevenness of the flow is due to differences in analytical skills. Formal publication of forecasts may alleviate, but probably will not solve, the problem of uneven information flow.

3. Formal publication of forecasts may create some problems. Perhaps potentially the most serious problem is that if investors place too much emphasis on short run results as revealed in quartely or annual forecasts, the volatility and liquidity of the securities markets may be adversely affected...

4. The more detailed a forecasts is, the more likely it is to be of service to investors and the less likely it is to create problems of misuse and misinterpretation. Particularly important components of a forecast are the underlying economic assumptions. There is wide agreement that a single EPS figure would be of no value and would also create the most potential for abuse. It is important that a formal forecasting system include provision for adequate distribution of the forecast information. Merely requiring that the forecast be filed with the SEC is probably insufficient.

5. The market, rather than the SEC, should serve as the "policing authority" for forecasting errors short of fraud. Forecasts should not be audited.

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30. Ibid., p. 77.

6. While many feel philosophically opposed to a mandatory forecast, there is skepticism as to the effectiveness of permissive regulation. Should SEC adopt a permissive regulation, it should be prepared to move to required forecasting if permissive forecasting proves ineffective.[31]

The American Accounting Association (AAA)

The AAA Committee to Prepare a Statement of Basic Accounting Theory opposed the idea of the CPA reporting on management forecasts. The Committee acknowledged that external users of financial information use such information to make predictions and decisions. The Committee stated that "almost all external users of financial information reported by a profit oriented firm are involved in efforts to predict the earnings of the firm for some future period."[32]

However, the Committee felt that the independent accountant should report on past earnings only, and not project or report on management projections of future earnings. Lack of verifiability appears to be the main reason for the Committee's position. It specifically wrote :

> Failure to observe the standard of verifiability to a minimum degree would place the accountant, in some cases, in the role of forecaster and would reduce the confidence of the user and thereby diminish the usefulness of accounting reports. We believe that a substantial level of verifiability is most important for externally reported accounting information.[33]

In a more recent report, the Committee on Auditing Concepts concluded that the audit function should not be extended to reporting on forecasts.[34]

American Institute of Certified Public Accountants (AICPA)

Before we proceed with the presentation of the AICPA's official position, we will discuss the views of the Study Group on the Objectives of

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31. Ibid., p. 85.

32. AAA, *A Statement of Basic Accounting Theory*, p. 23.

33. Ibid., p. 27.

34. Committee on Basic Auditing Concepts, «Report: A Statement of Basic Auditing Concepts,» *Accounting Review*, Supplement to Vol. XLVII, 1972, pp. 14-74.

Financial Statements which considered the issue of financial forecasts and it reached a number of conclusions.[35]

In developing financial statement objectives, the Study Group was concerned with making information more useful, while preventing the introduction of inaccurate or unreliable data. This concern was great with respect to the publication of forecasts, whether contained in formal statements or in informal presentations of management's expectations. The Study Group accepted the notion that publication of forecasts might make financial statements more comprehensive and useful, but it pointed out that the uncertainty in forecasting could diminisn the usefulness of the information.[36]

The Study Group noted that forecasts are often communicated informally in speeches, press releases, and president's letters, and that several puplicly held companies have published formal forecasts[37]. The issue, however, was not "whether forecasts should be made, but whether they should be included in financial statements."[38]

The Study Group did not feel that the accuracy of forecasts was the prime consideration, but rather the relative accuracy of users' predictions with and witnout forecasts. If estimates of the future are enhanced, then forecasts should be published. The Group stated that «an objective of financial statements is to provide information useful for the predictive process. Financial forecasts should be provided when theywill enhance the reliability of users' predictions."[39]

With respect to reporting forecasts or projections the Group recommended the following :

1. Forecasts should be presented with their major underlying assumptions, so that each user can evaluate them in the context of his own needs. However, these assumptions should not be presented in such detail that their disclosure would adversely affect the firm's competitive position.

2. Ranges might be presented to supplement single numbers. The use

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35. AICPA, Objectives of Financial Statements.

36. Ibid., p. 46.

37. Fuqua Industries was the leader in this movement.

38. AICPA, Objectives of Financial Statements p. 46.

39. Ibid., p. 46.

of ranges would remind users that the forecast deals with estimates and should not be considered to be precise.

3. Forecasts should be updated and compared with actual accomplishments. The preparer should explain any significant differences between the original and revised forecasts and between forecasts and actual results. [40]

The AICPA has taken a middle road position on the issue of management forecasts. While the Institute agreed with the SEC's objectives for "equitable dissemination" of forecast information, (the SEC's position is discussed later), it maintained that no action should be taken by the SEC before appropriate guidelines for the preparation, presentation and disclosure of forecasts have been established. Following the development of such guidelines, the Institute suggested that a trial period of permissive publication of forecasts would be appropriate. This trial period would provide the necessary experience to reach an informed decision on the desirability of publication.

In order to aid in the development of the necessary guidelines, the Institute has already issued two documents. The first document presents ten guidelines for preparing financial forecasts and developing forecasting systems. [41] These guidelines are discussed below :

1. A forecast should be presented as the single most probable forecasted result. In addition, the most probable result should be supplemented by ranges or probabilistic statements in order to underscore the uncertain nature of all forecasts.

2. The forecast should be prepared applying the accounting principles expected to be used when the events and transactions envisioned in the forecast occur.

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

4. Financial forecasts should be based on the best information, from whatever source, reasonably available at the time they are prepared.

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40. Ibid., pp. 46-47.

41. American Institute of Certified Public Accountants, Management Advisory Service Division, *Guidelines for Systems for the Preparation of Financial Forecasts*, AICPA, 1975.

5. The preparation of a forecast should be based on information which reeflets the plans of the firm.

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

7. The relative effect of variations in major underlying assumptions should be determined.

8. The forecasting system should provide adequate documentation of the forecast and the related forecasting process.

9. The forecast should be compared regularly with the actual results.

10. The forecasts should be reviewed and approved by management at the appropriate levels.

The second document is a statement of position and provides guidance as to presentation and disclosure for those who choose to issue financial forecasts.[42] The major provisions of the statement are discussed below :

The statement defines a forecast as an estimate of the most probable financial position, results of operations and changes in financial position jcr one or more future periods. Most probable means that the assumptions haxe 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 statement recommends that the forecasts should preferably be presented in the format of the historical financial statements expected to be issued. However, at a minimum, a forecast should include presentation of sales or gross revenues, gross profit, provision for income taxes, net income, extraordinary or unusual items, disposal of a segment of a business, primary and fully diluted earnings per share, and significant anticipated changes in financial position.

The forecast should be prepared on a basis consistent with tne generally

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42. American Institute of Certified Public Accountants, Accounting Standards Division, Statement of Position on Presentation and Disclosure of Financial Forecasts, AICPA, 1975.

accepted accounting principles expected to be used for the historical financial statements, and this should be disclosed in the forecast.

The single most probable forecasted result should be disclosed. However, the tentative nature of this result can be emphasized by also presenting ranges for the key measures.

It is not considered feasible to disclose all assumptions, but disclosure should be made of all assumptions considered by management as the most significant, and of their rationale or basis. The relative impact of a variation in a assumption should be disclosed when it would significantly affect the forecasted result. The assumptions need not be presented in such a manner or in such detail as would adversely affect the competitive position of the enterprise. The assumptions should be clearly labeled, and there should be an introductory statement explaining that the assumptions disclosed are not an all-inclusive list, and that the forecast is based on circumstances and conditions existing at the time it was prepared.

The statement does not prescribe a fixed period to be covered in the forecast. Rather, the period is to be based on management's ability to forecast and the user's needs.

The financial forecasts should be presented separately or clearly segregated from the historical financial statements and should be clearly labeled as "financial forecast".

Forecasts should be updated as promptly as possible, but they need not be updated if they were issued on a "one-time" basis for a specific purpose, in which case that should have been disclosed in the forecast. Also, forecasts need not be updated if the issuance of actual data for the pertinent period is imminent. When material changes in a forecast can not be quantified, appropriate disclosure should be made. If management decides that a current forecast should no longer be used but it is not appropriate to issue an updated forecast, this decision and the reasons for it should be disclosed.

It should be emphasized, however, that neither document advocates nor discourages the publication of financial forecasts.

In addition to the above two documents, the Institute has recently published a guide for an accountant's review of a financial forecast.[43] The im-

43. American Institute of Certified Public Accountants, Auditing Standards Board, *Guide for a Review of a Financial Forecast*, AICPA, October 1980.

portance of this document is apparent, since it is the first official guide dealing with the CPA's involvement with financial forecasts and the appropriate reporting by him on such forecasts. Although the guide, as it is noted in the guide, does not have the authority of a pronouncement by the Auditing Standards Board, AICPA members may be asked to justify departures from it if their work is challenged.

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

a) The forecast was properly prepared based on management's stated assumptions ;

b) The presentation comforms to the guidelines outlined in the Statement of Position on Presentation and Disclosure of Financial Forecasts;

c) The underlying assumptions provide a reasonable basis for management's forecast. [44]

The guide indicates that in order to evaluate the preparation of the forecast, the accountant should perform procedures which 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.... 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. [45]

The accountant should also perform procedures which 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. After performing these procedures :

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44. Ibid., p. 5.

45. Ibid., p. 11.

...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 and (2) that the assumptions are suitably supported. [46]

The guide recognizes that it is not feasible to list all assumptions. but it points out that the accountant should evaluate whether management's assumptions relate to all key factors upon which the financial results of the entity depend. [47]

In evaluating whether the assumptions are suitably supported, the accountant should focus on assumptions which are :

1. Material to the forecasted amounts.
2. Especially sensitive to variations.
3. Deviations from historical trends.
4. Especially uncertain. [48]

Finally, the guide, in addition to presenting illustrative review procedures to assist the accountant in planning reviews of financial forecasts, [49] discusses the types of the accountant's report on a review of a financial forecast. [50]

Securities and Exchange Commission (SEC)

The result of the public hearings held by the SEC in 1972 was, as indicated earlier, a statement by the Commission that it would allow, on a "voluntary" basis, publication of earnings forecasts under federal securities laws [51].

The Commission had always prohibited disclosure of earnings forecasts

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46. Ibid., p. 8.
47. Ibid., p. 9.
48. Ibid., p. 10.
49. Ibid., pp. 15-20.
50. Ibid., pp. 21-27.
51. Securities and Exchange Commission, «Statement by the Commission on the Disclosure of Projections of Future Economic Performance,» Securities Act of 1933, Release No. 5362 and Securities Exchange Act of 1934, Release No. 9984, SEC, Washington, D.C., February 2, 1973.

in financial statements filed with it on the grounds that publication in filings could lead to exaggerated expectiatons of company prospects and consequently would be detrimental to the investing public. However, on the basis of the information gathered at the hearings and on the basis of its experience in administering the securities laws, the Commission determined that changes in its policies would assist in the protection of investors and would be in the public interest. The Commission noted that forecasts were widespread in the market and were relied upon by investors and that investors did not have equal access to this material information.

The Commission identified management forecasts as information of significant importance to investors and indicated that such information should be available on an equitable basis to all investors. The Commission pointed out that it was taking the first steps toward integrating forecasts into the disclosure system and that it had made a number of determinations, which are discussed below :

1. Disclosure of projections (i.e., forecasts) in Commission filings should not be required except under the circumstances set forth in 7 and 8 below.

2. Companies that meet certain standards relating to their earnings histories and budgeting experience should be permitted to include forecasts in filings made with the Commission.

3. Forecasts so disclosed should meet certain standards, for example, the underlying assumptions should be set forth, the forecast should be of sales and earnings and be expressed as a reasonably definite figure, and forecasts should be for a reasonable period of time.

4. The forecast should be updated on a regular basis and whenever the company materially changes its forecast.

5. Any company that has filed a forecast should be allowed to cease filing a forecast if it discloses its decision and gives reasons for the change.

6. No statement of certification or verification of the forecasts by any third party should be permitted.

7. Any company that discloses forecasts outside of filings with th-Commission, whether through financial media, financial analysts or othera wise, should be required to file such forecasts with the Commission.

8. Any company subject to the reporting requirements of the Exchange Act that discloses a forecast, whether in a Commission filing or not, should be required to include in its annual report to the Commission for the fiscal year during which the projection was made, a statement of the forecast made, the circumstances under which it was disclosed, and a comparison of the forecast with actual results.

9. The Commission should clearly define the situations under which a forecast would not be considered to be a misleading statement of a material fact.

10. The Commission should issue a release setting forth certain standards for the preparation and dissemimation of forecasts by management, financial analysts, and other members of the financial community.

On April 28, 1975, the SEC announced its proposed rules for implementing its plan to intergrate projections into the disclosure system of the federal securities laws. [52] A summary of the proposed rules follows :

1. The proposal defines a "projection" as a statement made by a company regarding material future revenues, sales, net income or earnings per share expressed as a specific amount, range of amounts or percentage variation of a specific amount, or a confirmation by a company of any such statement made by another person.

2. Possible liability to investors has been of concern to those who have been or will be associated with forecasts. The proposed safe harbor rules were designed to protect those companies that make a forecast in situations where there is a strong likelihood of a reasonable forecast. Escape from liability will not be dependent upon achieving the forecast but upon meeting several requirements at the time the forecast was made. These requirements are discussed below :

a) The company must have been subject to the Exchange Act for at least three years and have filed all required reports during the prior twelve months. In addition, the company must have prepared budgets for internal use for the last three years. Presumably, the preceding could provide some assurance that the company has had enough experience in reporting publicly

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52. Securities and Exchange Commission, Securities Act of 1933, Release No. 5581 and Securities Exchange Act of 1934, Release No. 11374, SEC, Washington, D.C., April 28, 1975.

and in budgeting so that it has a reasonable basis for making public forecasts.

b) The forecast must have been prepared with reasonable care by qualified persons and reviewed and approved by management at the appropriate levels and must have a reasonable factual basis and represent management's good faith judgment.

c) The forecast must state at least sales or revenues, net income and fully diluted earnings per share ; it must express exact amounts, a reasonable variation from an exact amount or a reasonable range of estimates (a 10 percent variation or range not exceeding 10 percent from the midpoint is deemed reasonable) ; it must be limited to the current fiscal year, or if made after the second quarter, to the current fiscal year and up to an additional fiscal year.

d) The forecast must be identified as such and be accompanied by a statement disclosing the material assumptions underlying the forecast, cautioning that no assurance can be given that the forecast will be achieved, and indicating that the forecast is consistent with the accounting principles expected to be used by the company.

e) If the company states that the forecast has been reviewed by an outside party, a statement must be issued disclosing the degree of independence (or lack of independence) that the reviewer possessed and where the reviewer's report on forecast could be obtained. An otherwise independent accountant reviewing the forecast will not be deemed not independent with respect to financial statements of the company.

f) If the reviewer is not independent, the relationship between the company and the reviewer must be disclosed together with the amount of compensation involved as a result of such relationship.

g) If the reviewer furnishes a report to the company, that report must disclose the reviewer's independence and qualifications, the scope of the examination, and a statement that the reviewer is not giving assurance that the forecast will be achieved. In addition, there must be a statement that the forecast was based on assumptions made by the company and is consistent with the accounting principles expected to be used by the company, the assumptions underlying the forecasts are internally consistent, the procedures used by the company to arrive at the forecast are reasonable, and that the procedures have been applied in a consistent manner.

Note that the Commission reversed its stand with respect to the certification or verification of forecasts as stated in the February 1973 statement. In that statement the Commission, however, noted that it would reconsider its position if generally accepted principles or policies concerning such verification were developed. Apparently, the Commission felt that progress had been made toward developing such principles or policies.

3. The forecast must be filed on Form 8-K within ten days of the forecast event. The four events that would initiate the filing of Form 8-K would be the furnishing of a forecast to any individual, revising a forecast, furnishing forecasts to a government agency which has not afforded the forecasts non-public treatment, and determining to cease disclosing or revising forecasts.

4. The proposal requires that a company which made forecasts compare published forecasts and any revisions with actual results in subsequent annual report filed with the Commission on Form 10-K and explain differences of 10 percent or more. The company also must prepare a forecast for the 10-K covering at least the first six months of the subsequent year.

On April 23, 1976, the SEC, recognizing the important legal, disclosure policy, and technical issues raised by the commentators on the above proposals, decided to withdraw the various rule and form proposals relating to forecsats.[53] As can be gathered, these proposals would have established an elaborate disclosure system for companies choosing to make public projections.

The Commission, however, indicated that it would not object to including forecsats in filings. Companies can make a forecast without including it in a SEC filing, but the Commission urged them to avoid "selective disclosure".

Because of the diversity of views on the "importance and reliability" of forecasts, the Commission was neither encouraging nor discouraging the making and filing of forecasts. The Commission felt that the issue of forecasts might be among those appropriately considered by the Advisory Committee on Corporate Disclosure. Thus, the Commission wanted to wait for the Advisory Committee's report before it was to take any further steps.

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53. Securities and Exchange Commission, Securities Act of 1933, Release No. 5699 and Securities Exchange Act of 1934, Release No. 12371, SEC, Washington, D.C., April 23, 1976.

In addition to permitting optional filing of forecasts, the Commission proposed new guidelines for the voluntary inclusion of forecasts in filings and pointed out that it would follow them until the final guidelines were issued. The proposed guidelines provide that a forecast filed with the SEC must be based on reasonable judgments made in good faith, must be in an appropriate format, and disclosures must be sufficient for a reader to understand the basis for the forecast and its limitations. The proposal would allow, but not require, review of the forecast by a third party.

The proposal does not include the "safe harbor" provisions of the 1975 proposal which were intended to limit legal liabilities for inaccurate forecasts. However, the Commission is of the view that reasonably based and adequately presented forecasts should not subject a company to liability under the federal securities laws, even if the forecasts prove to be in error.

On November 3, 1977, twenty-one months after its formation, the Securities and Exchange Commission Advisory Committee on Corporate Disclosure submitted its final report to the SEC.[54] This independent body was charged with assessing the effectiveness of the corporate disclosure system in the United States and making recommendations for improvements to the system.

Although the Committee concluded that the basics of the present system should be continued and that major change in the federal securities laws or their administration is not needed, it, however, made a number of recommendations for improvement on a wide range of issues affecting the financial disclosure system.

With respect to projections of future company economic performance, the Committee favored the publication of such projections. Specifically, the Committee pointed out that management forecasts of sales and earnings are of special interest to investors and financial analysts and recommended that the SEC encourage their publication.

The Committee observed that there exists a wide-spread, informal system for communicating information about management projections. While most companies have mixed emotions about discussing their projections, mainly because of credibility and liability reasons, there are some who

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54. Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, Washington, D.C., Government Printing Office, 1977.

will, at least indirectly, convey their expectations to financial analysts. If the publication of projections becomes more widely accepted, communication among management, analysts and investors regarding management projections can be more direct. In addition, when companies formally publish projections they are likely to exercise greater care in preparing the information, and this would be a benefit to investors.

More specifically, the Committee recommended that the SEC issue a public statement encouraging public companies to disclose projections in their filings with the Commission. These disclosures should be subject only to the conditions that the projections be prepared on a reasonable basis, be disclosed in good faith, and be accompanied by an appropriate statement given recognition to the inherent uncertainty of the projections. The public statement should state the following:

1. Disclosure of major assumptions underlying projections, comparisons of previous projections with actual results, and management analysis of the variance should be encouraged but not required.

2. The items of information to be forecasted, the time period to be covered by the forecast, and the decision to discontinue forecasting should rest within the discretion of management.

3. Third party review of projections should be permitted but not required.

4. Projections previously issued that are still current at the time a registration statement is filed should be required to be included in the registration statement with appropriate updating if necessary.

To further encourage disclosure of projections, the Committee recommended that the Commission adopt a safe-harbor rule. The rule would provide protection from liabilities unless it is proven that the information was prepared without a reasonable basis or was disclosed other than in good faith.

In discussing the reasons why a voluntary projections disclosure program is more appropriate than a mandatory program, the Committee pointed out:

1. A mandatory system would necessitate the formulation of specific disclosure rules and regulations. The Committee is of the opinion that the Commission does not now have an appropriate basis for formula-

tion of such rules and regulations, and that a period of experimentation is warranted.

2. All public companies should not be required to sustain the expense and other burdens that may be associated with a program for the public disclosure of projections...

3. Public companies should not be compelled to expose themselves to the potential risks of liability and litigation for inaccurate projections.

4. Many companies would find it difficult, if not impossible, to prepare reasonable projections due to a lack of operating history, general economic factors or industry conditions.[55]

In response to recommendations made by the Advisory Committee, the SEC issued revised guidelines on November 7, 1978 to encourage companies to issue financial forecasts.[56] The Commission pointed out that the comments it received on the 1976 proposed guidelines and the Advisory Committee are in agreement with the view that a voluntary projection program is more appropriate than a mandatory program. Accepting that view, the revised guidelines continue to reflect the Commission's position that disclosure of projections be permitted but not required. The guidelines provide that a forecast filed with the SEC must be based on a reasonable basis, be presented in a appropriate format, and disclose suffic ientinformation for the reader to understand the basis for the forecast and its limitations.

The following paragraphs discuss the provisions of the above guidelines.

1. A company wishing to disclose a forecast does not have to meet any requirements pertaining to reporting history or experience in budgeting. The company is free to make a projection as long as it has a reasonable basis for such a projection.

2. Although no specific items are required to be projected, the Commission 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 to-

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55. Ibid., p. D-16.

56. Securities and Exchange Commission, Securities Act of 1933, Release No. 5992 and Securities Exchange Act of 1934, Release No. 15305, SEC, Washington, D.C., November 7, 1978.

gether in order to avoid any misleading inferences that may arise when individual items reflect contradictory trends. The Commission, however, recognizes that there may be instances when a company should be given flexibility in determining whether other or additional financial items should also be presented.

3. The period to be covered by the forecast is left to the discretion of management. This option was given in recognition of the many factors that affect the forecasting ability of each company.

4. Projections can be presented as the most probable specific amount or the most reasonable range. However, it was pointed out that ranges should not be so wide as to make a forecast meaningless.

5. Disclosure of the most significant assumptions underlying the forecasts is encouraged but not required. While the Commission believes that disclosure of the underlying assumptions would help investors to better understand the basis for and the limitations of forecasts, it, nevertheless, decided not to require disclosure of the assumptions, in order to make projecting more attractive to companies, until there is more experience with projection disclosure.

6. Companies are not required to update their forecasts, but the Commission reminds companies of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, as they occur.

7. Companies are free to discontinue or resume making projections as long as they have a reasonable basis for such action.

8. Management should consider whether disclosure of the accuracy or inaccuracy of previous forecasts would provide investors with insights into the limitations of forecasts. Analysis of the variances between forecasted and actual results on a continuing basis may highlight for investors the risky areas of a company.

9. Third party review is permitted but not required. If a company decides to include an outside review in an SEC filing, there should also be disclosure of the reviewer's qualifications, the extent of the review, and the relationship between the reviewer and the company.

On the day that the above guidelines were published, the Commission published also a proposed safe-harbor rule for projections whether or not

included in Commission filings.[57] The purpose of that rule was to further encourage companies to issue forecasts by not subjecting them to liability solely because the forecasts did not materialize. Specifically, the proposed safe-harbor rule (Version "A") provided that :

> A statement containing a projection of revenues, income (loss), earnings (loss) per share or other financial items shall be deemed not to be an untrue statement of a material fact, a statement false or misleading with respect to any material fact..., if such statement (1) was prepared with a reasonable basis and (2) was disclosed in good faith.

The above rule was to apply to statements made by or on behalf of a reporting company, other than a registered investment company, provided that the issuer had filed all the material required to be filed.

In addition to the above proposed rule (Version "A"), the Commission was requesting comments on an alternative version of the "safe harbor" rule (Version "B") recommended by the Advisory Committee on Corporate Disclosure in its final report. The Advisory Committee's proposed rule stated that :

> A statement of a management projection of future company economic performance or a statement of management plans and objectives of future company operations shall be deemed not to be an untrue statement of material fact ; a statement false or misleading with respect to any material fact..., unless such information: (1) was prepared without a reasonable basis ; or (2) was disclosed other than in good faith.

The two rules differ from each other in a number of points. The most important of these points are discussed below :

The proposed rule (Version "A") applies only to statements made by reporting companies, other than registered investment companies, whereas the Advisory Committee's rule is not so limited.

The proposed rule relates only to projections of revenues, income (loss), earnings (loss) per share or other financial items. The Advisory Committee's rule provides protection for a wider variety of forward looking information.

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57. Securities and Exchange Commission, Securities Act of 1933, Release No. 5993 and Securities Exchange Act of 1934, Release No. 15306, SEC, Washington, D.C., November 7, 1978.

The Commission's proposed rule places the burden of proof on the defendant to prove that a forecast was prepared with a reasonable basis and was disclosed in a good faith. The Advisory Committee's rule casts the burden of proof on the plaintiff to establish that the projection did not have a reasonable basis or was not made in good faith.

After considering the comments it received on the above two alternative rules, the Commission adopted a final safe-harbor rule on June 25, 1979 to encourage the disclosure of projections and other forward looking information.[58]

The provisions of that rule, which inporporates elements of both alternatives proposed for comments, are discussed below:

1. Statements containing or relating to a) projections of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items, b) management's plans and objectives for future company operations, c) future economic performance included in management's discussion and analysis of the summary of earnings or quarterly income statements, and d) disclosed assumptions underlying or relating to these statements would be deemed not to be false or misleading under the federal securities laws unless it is shown that such statements were made or reaffirmed without a reasonable basis or were disclosed other than in good faith.

2. Statements made by or on behalf of an issuer or by an outside reviewer hired by the issuer are protected by the rule.

3. The safe-harbor rule applies to reporting companies, other than registered investment companies, provided that they have filed their most recent annual report on Form 10-K. Non-reporting companies that include forward-looking statements in registration statements filed under the Securities Act are protected by the rule.

4. The rule covers statements made in filings with the Commission or in annual reports to shareholders. Statements made outside of these documents are covered by the rule only if these statements are reaffirmed in a filed document or annual report made publicly available within a reasonable time after the making of such statements.

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58. Securities and Exchange Commission, Securities Act of 1933, Release No 6084 and Securities Exchange Act of 1934. Release No. 15944, SEC, Washington, D.C., June 25, 1979.

CONCLUSIONS

This study discussed a number of issues surrounding the publication of management forecasts. The issue of disclosure of financial forecasts has been actively debated for almost a decade. This is an important issue that affects the entire financial community and the public in general.

The views expressed by a number of authoritative bodies and writers indicate that the benefits from formally issuing financial forecasts outweigh the cost of generating them. This, however, remains an open question until forecasts are attempted and a cost/benefit analysis is performed.

Companies, in general, are reluctant in formally issuing financial forecasts. To a degree, this reluctancy is justifiable considering the problems involved, but it is important to realize that the problems could be resolved and a general acceptability of publishing financial forecasts could be achieved.

The three documents issued by the AICPA, and the SEC's guidelines and safe-harbor rule have given answers to a number of questions and it seems that the stage is set for explanded experimentation. The message that comes out of the SEC's guides and the safe-harbor rule is the desire of the Commission to give companies the necessary time and flexibility to meet the need for the publication of forecasts.

In particular, companies sensitive to the needs of the investing public and committed to the idea that all information should be available on an equitable basis to all investors should lead the way to a regular and even dissemination of corporate expectations. In this respect, these companies should have the support of the SEC and the accounting profession if they are to succeed. Unwillingness to meet the challenge would, in the long run, be against the best interest of the companies involved and the public in general. The call of the present time is for the disclosure of more relevant information for investment decisions. Undoubtedly, financial forecasts meet the criterion of revelance.

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