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Proposed statement of position : questions concerning accountants' services on prospective financial statements : Proposed amendment to AICPA Guide for Prospective Financial Statements;Proposed amendment to AICPA Guide for Prospective Financial Statements : Questions concerning accountants' services on prospective financial statements

American Institute of Certified Public Accountants. Auditing Standards Division. Forecasts and Projections Audit Issues Task Force

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

QUESTIONS CONCERNING ACCOUNTANTS' SERVICES ON PROSPECTIVE FINANCIAL STATEMENTS

(Proposed Amendment to AICPA *Guide for Prospective Financial Statements)*

SEPTEMBER 2, 1988

Prepared by the Forecasts and Projections
Audit Issues Task Force, Auditing Standards Division,
American Institute of Certified Public Accountants

Comments should be received by November 2, 1988, and addressed to
Mimi Blanco-Best, Technical Manager, Auditing Standards Division, File 2660
AICPA, 1211 Avenue of the Americas, New York, N.Y., 10036-8775

SUMMARY

The Forecasts and Projections Audit Issues Task Force developed this proposed statement of position (SOP) in response to questions raised by practitioners about some of the procedural and reporting guidance contained in the AICPA Guide for Prospective Financial Statements ("the Guide"). This SOP includes some of these questions and the recommended responses. Specifically, the SOP provides additional guidance in these areas:

1. Reporting on financial forecasts that include a projected sale of an entity's real estate investment

2. Sales prices assumed in a projection of the sale of an entity's real estate investment

3. Reporting on information accompanying a financial forecast in an accountant-submitted document

4. Financial projections included in general-use documents

5. Support for tax assumptions

6. Periods covered by an accountant's report on prospective financial statements

The provisions of this statement would be effective when issued.

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September 2, 1988

Accompanying this letter is an exposure draft of a proposed statement of position (SOP) entitled Questions Concerning Accountants' Services on Prospective Financial Statements. It has been prepared by the Forecasts and Projections Audit Issues Task Force. A summary of the proposed SOP also accompanies this letter.

The purpose of this exposure draft is to solicit comments from practitioners and other interested parties. It was developed to clarify and expand on the reporting and procedural guidance in the AICPA Guide for Prospective Financial Statements.

Comments and suggestions on any aspect of this exposure draft will be appreciated. It will be helpful if the responses refer to the specific paragraph numbers and include supporting reasons for any suggestions. Comments received by the AICPA will be considered by the Auditing Standards Division when it reviews the final SOP.

Comments on this exposure draft should be sent to the Auditing Standards Division, File 2660, in time to be received by November 2, 1988. Written comments on the exposure draft will become part of the public record of the AICPA for one year after such date.

Yours truly,

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(1988)

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QUESTIONS CONCERNING ACCOUNTANTS' SERVICES ON PROSPECTIVE FINANCIAL STATEMENTS

REPORTING ON FINANCIAL FORECASTS THAT INCLUDE A PROJECTED SALE OF AN ENTITY'S REAL ESTATE INVESTMENT

Question:

1. The AICPA Guide for Prospective Financial Statements ("the Guide") states that "short-term financial forecasts may not be meaningful in (a) industries with a lengthy operating cycle or (b) situations where long-term results are necessary to evaluate the investment consequences involved. It may not be practical in all situations to present financial forecasts for enough future periods to demonstrate the long-term results. In those circumstances, the presentation should include a description of the potential effects of such results. For example, if a real estate entity's forecast does not extend to the period in which the entity's investment is expected to be liquidated, the disclosures would include a discussion of the effects of a liquidation at the end of the forecast period. Exhibit 3 in section 410 illustrates such a disclosure."[1] The information in exhibit 3 is presented in a note to a financial forecast. How should the practitioner report on a financial forecast that includes a hypothetical sale of an entity's real estate investment at the end of the forecast period?

Answer:

2. The hypothetical sale of an entity's real estate, presented to demonstrate the potential effects of long-term results, may appear in the notes to the financial forecast or in a separate statement presented as part of the financial forecast. Such presentations should be appropriately labeled and accompanied by applicable disclosures, including significant assumptions and an indication of the purpose of the presentation.

3. When the effects of a hypothetical sale of an entity's real estate are included in a note to the financial forecast, the disclosure is part of the financial forecast and the accountant's standard report encompasses it. If the hypothetical sale is presented as a projection in a separate statement, the accountant's report should be modified to report specifically on the statement. Examples of appropriate forms of reports follow.

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1 See section 400.33 of the Guide for Prospective Financial Statements (New York: AICPA, 1986).

Examination

We have examined the accompanying forecasted balance sheet of XYZ Company as of December 31, 19X8, and the related forecasted statements of income, retained earnings, and cash flows for the year then ending (the forecast), and the accompanying statement of the effect on limited partners of the projected sale of property at December 31, 19X8 (the projection). Our examination was made in accordance with standards for an examination of prospective financial statements established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the statements.

The accompanying projection was prepared by management to provide potential investors with information to analyze the effect of a hypothetical sale of the properties as of December 31, 19X8, and should not be considered to be a presentation of expected future results.

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

Compilation

We have compiled the accompanying forecasted balance sheet of XYZ Company as of December 31, 19X8, and the related forecasted statements of income, retained earnings, and cash flows for the year then ending (the forecast), and the accompanying statement of the effect on limited partners of the projected sale of property at December 31, 19X8 (the projection). Our compilation was made in accordance with standards established by the American Institute of Certified Public Accountants.

The accompanying projection was prepared by management to provide potential investors with information to analyze the effect of a hypothetical sale of the properties as of December 31, 19X8, and should not be considered a presentation of expected future results.

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

4. In rare cases, management may forecast the sale of its investment in real estate during the forecast period. In such circumstances, the sale would not be hypothetical and should be included in the financial forecast with other operating results and significant changes in financial position. Furthermore, the sale would be covered by the accountant's standard report.[2]

SALES PRICES ASSUMED IN A PROJECTION OF THE SALE OF AN ENTITY'S REAL ESTATE INVESTMENT

Question:

5. Section 400.33 of the Guide states that it may not be practical in all situations to present financial forecasts for enough future periods to demonstrate the long-term results of investment decisions. In those circumstances, the presentation should include a description of the potential effect of such results. For example, the Guide indicates that if a real estate entity's forecast does not extend to the period in which the entity's investment is expected to be liquidated, the forecast would include a discussion of the effects of a liquidation at the end of the forecast period, as shown in exhibit 3 in section 410.[3]

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[2] In such rare circumstances, the accountant should treat this the same as any other significant assumption. For example, when examining the forecast, the accountant should consider whether the assumptions related to the sale have a reasonably objective basis and are suitably supported (for example, with respect to timing and sales price). The accountant should also consider whether the assumptions should be identified by the responsible party as being particularly sensitive. Section 400.25 of the Guide discusses the identification and disclosure of particularly sensitive assumptions.

[3] This disclosure can be presented as a footnote to a financial forecast or as a separate schedule within the forecast. (See "Reporting on Financial Forecasts That Include a Projected Sale of an Entity's Real Estate Investment" on page 5.)

6. When disclosing the effects of a hypothetical liquidation (sale) of the entity's real estate investment at the end of the forecast period, what are appropriate assumptions for the sales price?

Answer:

7. The Guide states (400.04P) that although the responsible party need not have a reasonably objective basis for the hypothetical assumptions used in a projection, those assumptions should be consistent with the purpose of the projection. The purpose of disclosing the effects of a hypothetical sale of an entity's real estate investment at the end of the forecast period is to provide users with meaningful information about the long-term results of their investment decisions.

8. Typically, the sales price is based on a specified capitalization rate of forecasted cash flows. To be consistent with the purpose of disclosing the hypothetical sale of the entity's real estate investment, the capitalization rate assumed should be consistent with the assumptions used in the forecast as well as with the entity's and the industry's experience. If the capitalization rate assumed is not consistent with the entity's or the industry's experience, the responsible party should consider whether the resulting projected sales price is appropriate, since it may result in a presentation that is inconsistent with the objective of providing users with meaningful information about the long-term results of their investment decisions.

9. Other sales prices may also be consistent with the purpose of the projection. For example, when significant nonrecourse debt is involved, the sales price assumed is often the existing mortgage balance or the existing mortgage balance plus original capital contributions.[4] Such assumed sales prices provide meaningful information that helps investors analyze their investment risk.

REPORTING ON INFORMATION ACCOMPANYING A FINANCIAL FORECAST IN AN ACCOUNTANT-SUBMITTED DOCUMENT

Question:

10. An entity may request that additional details or explanations of items in a financial forecast (for example, details of sales or forecasted product line information) be included in an accountant-submitted document that contains a financial forecast and the accountant's report thereon. Such information is presented outside the financial forecast and is not considered necessary for the presentation of the forecast to be in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants. How should the accountant report on such information when he or she has not been engaged to examine the information separately?

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4 Guide section 400.23P states that "the responsible party should identify which assumptions in the projection are hypothetical. In addition, if the hypothetical assumptions are improbable, the disclosure should indicate that."

Answer:

11. An accountant's report on information accompanying a financial forecast in an accountant-submitted document has the same objective as an accountant's report on the financial forecast: to describe clearly the character of the accountant's work and the degree of responsibility taken. When an accountant has examined a financial forecast included in an accountant-submitted document, the accountant's report on additional details or explanations of items in the financial forecast would ordinarily include all of the following:

a. A statement that (1) the examination has been made for the purpose of forming an opinion on whether the financial forecast is presented in conformity with AICPA guidelines for the presentation of a forecast and (2) the underlying assumptions provide a reasonable basis for the forecast

b. Identification of the accompanying information

c. A statement that the accompanying information is presented for purposes of additional analysis and is not a required part of the financial forecast

d. A disclaimer of opinion

e. A caveat that the prospective results may not be achieved

12. The accountant should exercise care in reporting on such information to avoid giving the impression that he or she is expressing assurance on it. For example, the report should not include statements about the mathematical accuracy of the information or its conformity with presentation guidelines. Also, the accountant should consider whether the disclosures in the financial forecast and accompanying information are sufficient to enable the reader to evaluate the accompanying information.[5] Following is an example of a report that may be issued.[6]

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5 If the accountant concludes, on the basis of known facts, that any accompanying information is materially misstated in relation to the financial forecast taken as a whole, or if the accountant believes that the related disclosures are insufficient to enable a reader to evaluate the accompanying information, he or she should discuss the matter with the responsible party and propose appropriate revision of the accompanying information or related disclosures. If the responsible party will not agree to revision of the accompanying information, the accountant should either modify the report on the accompanying information and describe his or her reservations regarding the information or refuse to include the information in the document.

6 The report may be added to the report on the financial forecast or may be presented with the accompanying information.

> Our examination of the financial forecast presented in the preceding section of this document was made for the purpose of forming an opinion on whether the financial forecast is presented in conformity with AICPA guidelines for the presentation of a forecast and whether the underlying assumptions provide a reasonable basis for the forecast. The [identify accompanying information] is presented for purposes of additional analysis and is not a required part of the financial forecast. Such information has been subjected to procedures applied in the examination of the financial forecast; however, we have not examined the accompanying information in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, do not express an opinion on it. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

13. If additional details or explanations of items in a financial forecast are included in an accountant-submitted document that includes a financial forecast and the accountant's compilation report thereon, the accountant's compilation report should also cover the other data. For example, the following may be added to the accountant's standard compilation report on a financial forecast.

> We also compiled [identify the accompanying information] and, accordingly, do not express an opinion or any other form of assurance on such information.

FINANCIAL PROJECTIONS INCLUDED IN GENERAL-USE DOCUMENTS

Question:

14. The Guide for Prospective Financial Statements indicates that, if a client expects to include a financial projection (as defined in section 200.05 of the Guide) in a general-use document, an accountant should not submit the projection to the client or provide the client with any type of report thereon unless the projection is used to supplement a financial forecast for a period covered by the forecast.[7] What is an accountant's responsibility for a projection (not used to supplement a financial forecast for the period covered by the forecast) included in a client-prepared general-use document when historical financial statements and the accountant's report thereon are included in the same document?

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7 Section 500.12P of the Guide states that "an accountant...should not submit or report on or consent to the use of his name in conjunction with a financial projection that he believes will be distributed to those who are unable to negotiate directly with the responsible party...." Also, see section 210.05 of the Guide.

Answer:

15. If an accountant consents to the use of his or her report on historical financial statements in a client-prepared general-use document that contains a financial projection, the projection should be accompanied by an indication from the responsible party or the accountant that the accountant has not examined, compiled, or applied agreed-upon procedures to the projection and that the accountant assumes no responsibility for it.[8] If the accountant has audited the historical financial statements, he or she should refer to SAS No. 8, Other Information in Documents Containing Audited Financial Statements. Although the accountant should consider informing the responsible party that the presentation of a financial projection in a general-use document is not in conformity with the Guide, the use of such a projection in a general-use document is not presumed to be a material misstatement of fact.

Question:

16. What is the accountant's responsibility for a financial projection (not used to supplement a financial forecast for the period covered by the forecast) included in a client-prepared general-use document when a financial forecast and the accountant's report thereon are included in the same document?

Answer:

17. If an accountant consents to the use of his or her report on a financial forecast in a client-prepared general-use document that contains a financial projection for a period not covered by the forecast, the projection should be accompanied by an indication from the responsible party or the accountant that the accountant has not examined, compiled, or applied agreed-upon procedures to the projection and that the accountant assumes no responsibility for it. In addition, the accountant should refer to the guidance in sections 500.22 through 500.27 of the Guide and consider informing the responsible party that the presentation of a projection for a period not covered by the forecast in a general-use document is not in conformity with the Guide.

SUPPORT FOR TAX ASSUMPTIONS

Question:

18. Sometimes one of the most sensitive assumptions underlying a financial forecast relates to the income tax treatment of prospective transactions. To obtain a reasonably objective basis for such tax assumptions, the responsible party may obtain a "tax opinion" from another practitioner, such as the entity's tax counsel or another accountant. What responsibility does an accountant examining a financial forecast have in considering whether the tax opinion provides suitable support for tax assumptions underlying the financial forecast?

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8 See section 500.20 of the Guide.

Answer:

19. Technical training and experience, as well as knowledge of the client and its industry, enable the accountant to be knowledgeable about income tax matters and competent in assessing their presentation in prospective financial statements. Therefore, when carrying out procedures to evaluate another practitioner's tax opinion, the accountant is viewed as being one who is knowledgeable of income tax matters related to the entity's forecast.[9]

20. In determining whether another practitioner's tax opinion provides suitable support for tax assumptions[10] underlying a financial forecast, the accountant should--[11]

a. Obtain a copy of the form of the tax opinion expected to be issued.

b. Apply the following procedures from SAS No. 11, Using the Work of a Specialist, paragraphs 5 through 8:

1. Consider the professional qualifications and reputation of the other practitioner.

2. Consider the relationship, if any, of the other practitioner to the responsible party.

3. Obtain an understanding of the nature of the work to be performed by the other practitioner.

4. Obtain an understanding of the methods or assumptions used by the other practitioner to determine whether findings are suitable for corroborating the representations in the forecast.

5. Make appropriate tests of any accounting data provided by the client to the other practitioner.

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9 The tax opinion provided by the other practitioner may address matters of a legal nature not directly related to amounts included in the forecast--for example, matters related to the legal form of the entity. Accountants are not expected to have the technical training and experience necessary to form an opinion on legal matters.

10 Section 700.20 of the Guide for Prospective Financial Statements states that "the accountant should evaluate whether assumptions have been developed for all key factors upon which the entity's financial results appear to depend." When evaluating a tax opinion, the accountant should take into account whether all material tax issues have been considered.

11 See section 700.31 of the Guide for Prospective Financial Statements. Also, if an accountant is relying on the opinion of another practitioner in connection with a tax shelter offering, reference should be made to Internal Revenue Service regulations regarding tax shelter opinions (see appendix D of the Guide).

6. Consider whether the other practitioner's findings support the related representations in the prospective financial statements. In doing this, the accountant should read the tax opinion and consider whether (a) the facts used in the tax opinion are consistent with the information obtained during the examination of the forecast, (b) the assumptions and arguments used in the tax opinion are reasonable,[12] and (c) the assumptions, facts, and arguments used in the tax opinion support the conclusions reached.

PERIODS COVERED BY AN ACCOUNTANT'S REPORT ON PROSPECTIVE FINANCIAL STATEMENTS

Question:

21. The Guide for Prospective Financial Statements includes an example of an accountant's examination report on a financial forecast "for the annual periods ending December 31, 19X2 through 19X6."[13] The examination report states that the forecast was examined and concludes that (a) the forecast is presented in conformity with the presentation guidelines established by the American Institute of Certified Public Accountants and (b) the underlying assumptions provide a reasonable basis for management's forecast. Does the accountant's examination report on a financial forecast apply to the forecast taken as a whole or to each of the discrete periods presented in the forecast?

Answer:

22. The accountant's report on a financial forecast should correspond to the form of the forecast. Accordingly, if the forecast is presented in a columnar format in which each column represents a specific period, the accountant's report on the forecast applies to each period presented in the forecast. Conversely, an accountant's report would pertain to the entire period covered by the forecast (taken as a whole) if the presentation included a single column labeled "for the six years ending December 31, 19X6."

23. When an accountant examines a financial forecast that presents individual discrete periods, he or she should evaluate the support for the underlying assumptions used in preparing the forecast for each period presented.[14]

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12 See note 9.

13 See the illustrative report for a financial feasibility study in section 720.20 of the Guide.

14 Section 700.05 of the Guide states: "Materiality is a concept that is judged in light of the expected range of reasonableness of the information, and therefore users should not expect prospective information...to be as precise as historical information."