

GUIDANCE NOTE ON ACCOUNTANTS' REPORT ON PROFIT FORECASTS AND/OR FINANCIAL FORECASTS

Foreword

Traditionally, the attest function performed by our members has been in relation to past events. However, our growing and dynamic society has now started seeking professional association in its exercises relating to future. A manifestation of this is the requirement of banks and financial institutions regarding the preparation of projected cash flow and profitability statements by intending borrowers for the purpose of making an appropriate appraisal of their loan applications. These institutions place a greater reliance on such statements if they are prepared or reviewed by chartered accountants. As a large number of our members are undertaking the preparation and review of profit and financial forecasts for submission to banks and financial institutions, the Council of the Institute decided to issue this Guidance Note.

The Guidance Note discusses the important matters to which the accountants should direct their attention in reviewing the forecasts. It also suggests, as an illustration, a model of an unqualified report which may be given by the accountants.

I am grateful to Shri A.C. Chakraborti, Chairman of the Research Committee, who prepared the basic draft of this note. I also express my gratitude to the members of the Research and Ethical Standards Committees for their valuable suggestions for the finalisation of the Note.

I trust, this Guidance Note would be of help to all those who are involved in the preparation and review of financial forecasts.

New Delhi
1st September, 1982

Bansi S. Mehta
President

Handbook of Auditing Pronouncements-II

1. The Council of the Institute of Chartered Accountants of India is issuing this Note for the guidance of those members ("reporting accountants") who are asked to give reports on profit forecasts and/or financial forecasts.
2. Banks and financial institutions ("the institutions") often request their clients to provide projected cash flow and/or profitability statements, etc., for an appropriate appraisal of the loan applications made to them. While these institutions have their own yardsticks for review and scrutiny of such documents, before loans and advances are sanctioned, greater reliance is placed on such forecasts when they are reported upon by chartered accountants. This is largely because such institutions have recognised the advantages accruing from an independent review of such statements,
3. There have also been cases, particularly with regard to sick companies, where firm of chartered accountants have been called upon by the institutions to examine a company's operations and submit a review report for their consideration. In fact, there are numerous instances where chartered accountants have carried out detailed studies to identify the causes of sickness of an enterprise and suggested remedial measures for its rehabilitation. While rehabilitation of a sick enterprise is also dependent on technical production and marketing considerations, the need for appropriate assessment of financial requirements assumes considerable importance, because in most cases, finance continues to be an essential element in the rehabilitation process. It, therefore, appears that professional accountants will progressively be called upon to play an important role in connection with forecasts concerning the activities of industrial enterprises.
4. In issuing this Guidance Note, the Council has considered the provisions of clause (3) of Part I of the Second Schedule to the Chartered Accountants Act, 1949. This clause provides that a chartered accountant in practice shall be deemed to be guilty of professional misconduct "if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast."
5. After consideration of the various factors, the Council is of the opinion that the above clause does not preclude a chartered accountant from associating his name with forecasts. He can participate in the preparation of profit or financial forecasts and can review them, provided he indicates clearly in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and so long as

Accountants' Report on Profit Forecasts and/or Financial Forecasts

he does not vouch for the accuracy of the forecasts. It is also clear that the words "vouch for the accuracy of the forecast" do not refer to the arithmetical accuracy. The Council recognises that all forecasts are estimates based on certain assumptions, duly evaluated on a consideration of various relevant factors and, as such, are not capable of being ascertained with accuracy. This is a special feature incidental to all forecasting processes and is distinct from audited and other statements reported upon by chartered accountants.

6. Financial or profit forecasts are normally prepared solely for internal use by the management of companies but they may for special reasons be also prepared and submitted in response to a request from outside bodies like banks and financial institutions.

7. It is emphasised that all forecasts depend, to a large extent, on the nature of the business, with its numerous and substantial uncertainties. Therefore, such forecasts are not capable of verification by the reporting accountants in the same way as financial statements which present the results of a completed accounting period. As a natural concomitant, the reporting accountants should bear in mind the special nature of this review, and should do nothing to encourage the users of such forecasts to have a more optimistic or pessimistic picture than what is justified by the various assumptions behind the forecasts which depend on an appropriate assessment of all prevailing factors including those which are likely to change. This is necessary because the achievement of the future results is always subject to various uncertainties. In preparing or reporting on the forecasts, the reporting accountants should examine whether these have been based on appropriate assumptions and data and are presented on a consistent basis.

8. In rendering assistance in the preparation of the forecasts or in reporting thereon, the reporting accountants are advised to obtain clear instructions regarding the following matters:

- (i) the time-frame for which the forecasts are required to be prepared ;
- (ii) significant commercial, financial and other assumptions behind the forecasts;
- (iii) the purpose for which the forecasts are required and the circumstances calling for the reporting accountants to report thereon ;
- (iv) the underlying assumptions and the data base emanating from the

Handbook of Auditing Pronouncements-II

forecasts; and

- (v) the persons who are expected to use the forecasts.

9. In carrying out the review, the main matters to which the reporting accountants may direct their attention are as follows:

- (i) the nature and background of the company's business ;
- (ii) the accounting practices normally followed by the company ;
- (iii) the assumptions on which the forecasts are made ;
- (iv) the procedures, if any, followed by the company for preparing forecasts. For this purpose, the company's financial and profit forecasting methods should be studied and the existing policies, methods and procedures, systematically applied by the company should be reviewed;
- (v) where budgets, plans, goals and objectives, which are elements essential to prediction of future are available, they should also be subjected to review for developing an appropriate forecasting base. For this purpose, the past forecasts and actuals should be compared to find out reasons for variations;
- (vi) the trend of the country's economy in general and that of the industry in particular, to which the company belongs. The comparative strengths and weaknesses of the company in the industrial environment in which it operates, should be duly considered in determining the appropriate forecasting base. Marketing strength is a vital element in this respect and it will be useful to know the company's present share of market and future prospects.

10. In carrying out the review of forecasts, the following further matters should also receive appropriate attention:

- (i) Whether the forecast has been prepared by following consistent accounting policies.
- (ii) Whether adequate provision has been made for future losses and contingencies. This will require special attention in case of long term contracts, involving material amounts.
- (iii) Whether adjustment is required for exceptional items of income and expenditure.
- (iv) All profit/financial forecasts involve determination of fund requirements

Accountants' Report on Profit Forecasts and/or Financial Forecasts

both for capital and revenue purposes. Adequate provisions for working capital and long term finance are essential to the success of future operations and, as such, these should be appropriately reviewed, Cash Flow Statements substantiate and justify the company's future cash needs, and are, therefore, to be carefully reviewed.

- (v) Profit forecasts for sick companies present special problems. An in-depth look into the company's past affairs may give valuable information. Division or unit-wise analysis is important for all forecast exercises and this assumes special importance in the case of sick companies.
- (vi) Inter-firm comparisons provide useful information as regards the company's working results and financial soundness *vis-a-vis* the competitors engaged in the same industry. Such comparisons also help in reviewing the reasonableness of the various assumptions, which form the basis of the forecasts. In this connection, all major variations should be looked into so as to ensure that the assumptions adopted for forecast purposes are reasonable when compared with the performance of the competing firms.
- (vii) Where provisions have been made in the forecasts to cover effects of inflation and other contingencies, adequate information concerning thereto should be given.

11. On occasions, the reporting accountants are also required to undertake feasibility studies. In such cases, very often the reporting accountant has to depend on information provided by technical or marketing experts. Where the reporting accountant has relied on the reports of technical and other experts, he may indicate in his report the extent and the basis of such reliance.

12. Accountants' Report

- (i) Normally, the accountants' report should be addressed to the Board of Directors of the company, unless circumstances require a different procedure.
- (ii) In carrying out a forecast study, the reporting accountant should ascertain, at the beginning of the study, the precise terms of reference so that confusion in this respect is avoided. The objectives and terms of reference agreed to should be included as forming part of the report, so

Handbook of Auditing Pronouncements-II

that the report can in its totality be appreciated by reference to its nature, scope and objective.

- (iii) Where the reporting accountant feels that a particular area, which, though relevant to the report, is not covered by the terms of reference, he should qualify his report to limit his responsibility in relation thereto. If, based on his study, the reporting accountant finds himself unable to agree with the forecasts prepared by the company or has material reservations, he should qualify his report accordingly.
- (iv) While submitting a report on profit forecasts of sick companies, the reporting accountant should wherever required by the terms of reference, give forewarning signals, so that remedial action may be initiated by the concerned authorities.
- (v) Where the accountant has been compelled to limit the scope of his study, for example, due to time constraints, he should indicate in his report appropriate qualification or disclaimer so as to dispel any doubt about the conclusions which may be arrived at, based thereon.
- (vi) It is difficult to prescribe any particular form of report applicable to all circumstances. The reporting format will vary from case to case, depending on the nature of the specific assignment and the circumstances calling for such report and also the probable uses of the report. However, a reporting accountant should take care not to give any impression that he is vouching for the accuracy of the forecast.
- (vii) Subject to what has been stated above, given below is an illustrative model of an unqualified report by the reporting accountant on profit or financial forecasts:--

The Directors,
X Ltd.,
New Delhi.

Dear Sirs,

"As requested by you, we have carried out a review of the Profit Forecast/Financial Forecast prepared by your company, for the period from to which, we understand, will be submitted to for consideration of your application for additional working capital facility, and report that the Profit Forecast/Financial Forecast as annexed hereto are based on:

Accountants' Report on Profit Forecasts and/or Financial Forecasts

- (1) the company's past audited statements of accounts for the periods ended;
 - (2) the various information and explanations given to or required by us;
 - (3) the methods of accounting followed ; and
 - (4) the major assumptions as set out on pages”
- (viii) The above format would be appropriate to cases where there is no reason for any reservation or qualification on the data produced or the assumptions considered. Where circumstances warrant qualifications, the report may be suitably modified to ensure that appropriate information relevant thereto has been given.