Analyzing Prospective Financial Information

PCAOB Inspection Results and Potential Implications for Preparers of PFI

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Prospective financial information (PFI) is often an area of focus in financial statement audits; especailly when fair value measurements are involved. As a result, company management can spend signficant time answering questions from and providing documentation to their auditors.

Over the past decade, audit quality issues have been identified by Public Company Accounting Oversight Board (PCAOB) inspections pertaining to PFI used in fair value measurements. In this document, we summarize common issues identified in PCAOB Part I comments[1] pertaining to PFI. While these comments address deficiencies in the audit process, they often highlight areas where risk could exist and may provide insight to preparers wishing to better support PFI.

If you are in a financial reporting role, you will likley find this document to be of interest. Being aware of common pitfalls surrounding PFI can help you anticipate the areas where a greater level of documenation may be expected.

[1] Part I comments of the 2012-2020 Inspection reports for the Big 4 firms were reviewed.

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Common audit issues related to Prospective financial information[2]

There have been numerous comments issued by the PCAOB in reference to auditor procedures over PFI used in fair value measurements for impairment tests performed under ASC 350—Intangibles-Goodwill and Other (ASC 350) and ASC 360—Property, Plant and Equipment (ASC 360). In addition, other comments have arisen pertaining to forecasts used in the valuation of assets acquired or liabilities assumed in business combinations, including identifiable intangible assets, under ASC 805—Business Combinations (ASC 805). Most of these comments fall within one of the following categories.

- Evaluating an Entity's Ability to Meet a Forecast
- Assessing the Likelihood of Certain Events Occurring
- Evaluating Differences Between Forecasts and Actual Results
- Evaluating Differences Between Forecasts and Industry Expectations
- Addressing Disconfirming Information
- Supporting Critical Assumptions in the Forecast

This paper reviews PCAOB comments pertaining to each of these categories and explores best practices on how they may be addressed.

[2] Please note that this document illustrates some of the most common issues raised by the PCAOB regarding PFI and is not meant to be a comprehensive account of the PCAOB's comments.

Evaluating an entity's ability to meet a forecast

PCAOB Comments

"The firm performed certain substantive procedures to evaluate the significant assumptions underlying the cash-flow forecasts but did not obtain sufficient appropriate audit evidence regarding the issuer's ability to carry out its cost-saving strategies to achieve these forecasts."

"The firm concluded that the forecasted revenue growth rates were reasonable without performing any procedures, beyond inquiring of management, to evaluate the issuer's ability to carry out its planned strategies to achieve these forecasts."

At the crux of any evaluation of PFI is management's ability to execute on a forecast. This is even more critical when the PFI includes significant improvements in revenue growth or margin expansion. This can also be true when the forecast is higher than the levels achieved by the company in the past. As part of their internal controls over the preparation of the PFI, management needs to have appropriate controls in place over the key assumptions. This process should include challenging assumptions that appear aggressive, are inconsistent with their independent expectations, or may represent bias of the preparer of the PFI. The supporting documentation prepared by the management team should include the processes and controls the Entity has established over these assumptions.

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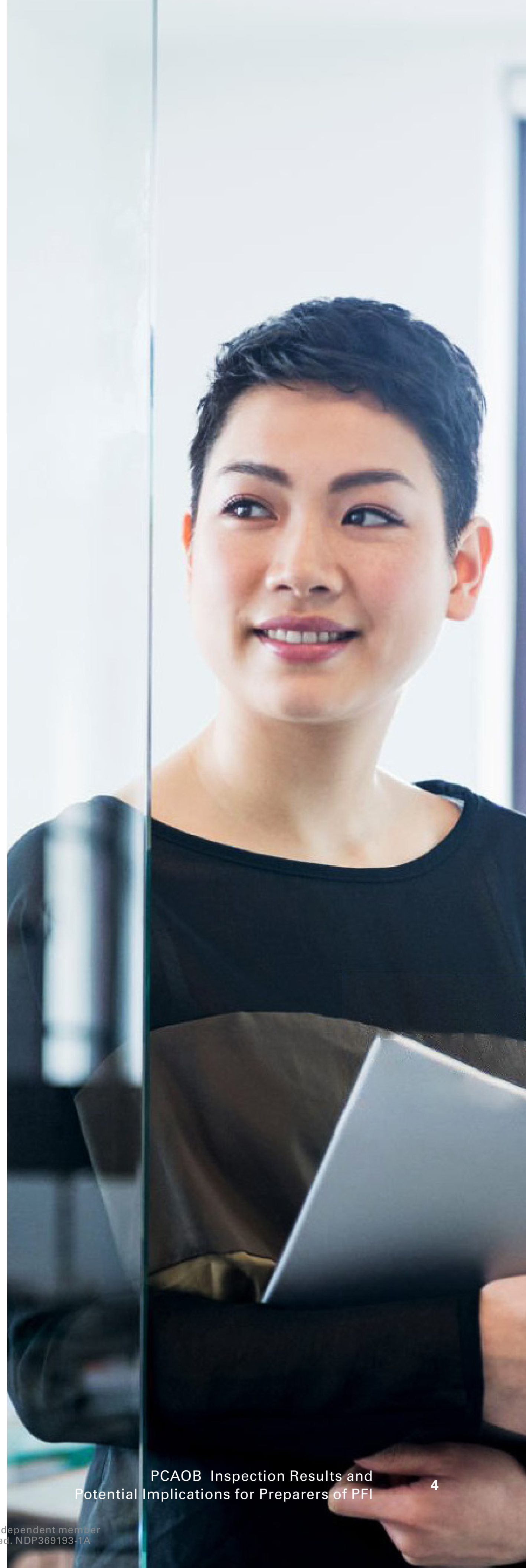
Assessing the likelihood of certain events occurring

PCAOB Comments

"The firm did not perform procedures to obtain evidence about the reasonableness of the probability weighting assigned to each of the cash-flow scenarios."

"The issuer used projected sales of three acquired products, adjusted by probability assumptions, to determine the fair value of certain contingent consideration arrangements related to the acquisition. The firm did not sufficiently evaluate the probability assumptions for all three products and the reasonableness of the projected sales for two of these products because its procedures were limited to inquiring of management and reading general market information."

During periods of higher uncertainty, management may use a range of PFI outcomes instead of a single base case forecast. When used in fair value measurements, it is important to have a well-documented assessment of the probabilities of each outcome. Assigning probabilities can be one of the more challenging aspects of scenario planning. Having a robust scenario development process and a good understanding of the risk vectors underlying each scenario is a key element for assigning reasonable probabilities to individual scenarios.



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Evaluating differences between forecasts and actual results

PCAOB Comments

“Failed to sufficiently evaluate significant differences between forecasts and actual results.”

“Failed to address the difference between projected SG&A expense assumption and the actual percentage for the prior year and the market participant average.”

“Failed to obtain additional evidence of reasonableness after certain assumptions in the cash flow forecast were found to be significantly different from industry data or historical rates.”

When preparing a financial forecast, one must be cognizant of any differences between the key assumptions used in the projections and historically achieved metrics. In addition, one must also be aware of management’s forecasting track record. Lastly, when potential differences are identified, it is important to address them in a well-documented manner.

Performing a gap analysis by benchmarking prior projections against achieved results provides valuable insights both in a company’s ability to forecast and execute against their business plan as well as provide an understanding of what went well and what did not. In addition, it allows for the identification of unanticipated factors (internal as well as external) that may need to be considered in developing PFI or scenarios going forward.

Evaluating differences between forecasts and industry expectations

PCAOB Comments

“The Firm failed to perform any procedures to consider whether the assumptions underlying the undiscounted cashflow analysis were consistent with relevant current market conditions and whether the issuer had the ability to achieve the projections.”

“For certain years within the forecast period, the firm’s procedures to evaluate the reasonableness of the revenue growth rates consisted of comparing the issuer’s forecasted revenue growth rate to those reported in an industry publication over the same period. The firm did not evaluate significant differences between the issuer’s forecasted revenue growth rates and the industry publication’s growth rate for these years.”

A critical step in getting comfortable with any forecast is assessing how it aligns with industry expectations. Additional consideration, explanation and documentation are necessary in situations where the company’s PFI deviates from the historical and projected financial performance of its peers. Any robust planning and budgeting process should consider benchmarking against industry peers and analyst data to the extent available.

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Addressing disconfirming information

PCAOB Comments

"The firm did not perform procedures, beyond inquiry, to evaluate significant differences it identified when performing certain comparisons to test the reasonableness of certain assumptions underlying the cash-flow forecasts that the issuer used to determine the fair value of the investments discussed above. In addition, the firm did not test the accuracy and completeness of certain data used in one of the comparisons."

"The Firm failed to perform sufficient substantive procedures to evaluate the reasonableness of the forecast that the issuer used in the goodwill impairment analysis, as it failed to sufficiently evaluate information that it obtained that appeared to be inconsistent with the forecast."

After analyzing differences between forecasts and industry expectations, it is also important to review the forecast for any potential inconsistencies within its assumptions. Any disconfirming information should be addressed by revising the forecast or discussing the relevant assumptions in the supporting documentation.

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Supporting critical assumptions in the forecast

PCAOB Comments

"Failed to sufficiently evaluate significant assumptions to develop revenue projections in the valuation of the acquired trademarks."

"Failed to sufficiently evaluate the reasonableness of the revenue growth-rate assumption used to determine the fair value of the acquired intangible assets and contingent consideration."

"The Firm's procedures to evaluate the projected revenue and margins that the issuer used to value certain acquired intangible assets were insufficient, as they were limited to comparing the projected results of the acquired company for the year to the actual results for the same period."

"The firm did not sufficiently test certain assumptions underlying the forecasted revenue that the issuer used to value one of these intangible assets beyond inquiring of management and comparing these assumptions to an issuer-prepared schedule."

Not surprisingly, one of the topics receiving the most comments is the revenue growth assumption used in PFI. In most forecasts, revenue growth rates can significantly impact value. This means a company should have a robust process to derive this assumption, starting with the underlying supporting data. For example, a company might benchmark their current revenue forecast against the company's historical revenue growth, as well as, the historical and projected revenue growth of its peer companies. Based on an assessment of the aforementioned factors, the current set of PFI can be developed, including further comparison to publicly available peer and industry historical and PFI data. Then, adjustments to revenue growth can be made based on the unique facts and circumstances of the subject entity (e.g. new product launch or product phase, new market entries, increases in marketing campaigns, etc.).

Overall, each assumption should be challenged and vetted by management. In addition, the underlying inputs, drivers, and overall forecasting process should be well documented. The goal is to develop a growth assumption that is reasonable when compared to the subject company's historical performance and when benchmarked to similar companies in the industry based on the supporting information.

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PCAOB Comments

"The SG&A percentages for the first three years of the forecast were significantly lower than both the prior-year percentage and the market participant averages, but the Firm's procedures to address the differences were limited to inquiring of management regarding anticipated changes in the business and noting that the anticipated changes were consistent with other transactions in the same industry."

"Failed to sufficiently evaluate the reasonableness of significant assumptions that the issuer used to develop the forecasted financial results used to project EBITDA and cash flows."

"The firm's procedures to test the forecasted gross margin percentages were not sufficient because they were limited to inquiring of management about the issuer's planned strategies and comparing the forecasted gross margin percentages to the actual gross margin percentages of another reporting unit."

"The firm did not perform any procedures to evaluate the reasonableness of certain forecasted expenses beyond comparing the current-year forecasted expenses to actual expenses."

After revenue growth, assumptions impacting operating profit margins are often among the most scrutinized PFI inputs. These assumptions will vary by industry but typically include COGS and the key components of SG&A expense. Given the importance of these assumptions, it is generally best to evaluate the reasonableness of each input and the resulting operating margins through historical levels observed for the subject company, historical levels observed for the publicly traded peer group, and if available, analyst forecasts. Any meaningful differences should be closely examined. Any such differences, if determined to be reasonable, should also be well documented.

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Key observations

Auditors are expected to perform a detailed analysis of PFI that considers more than general industry knowledge and management inquiry. Oftentimes, a comparison of forecasted cash flows to historical benchmarks are not sufficient. When management prepares a forecast, particularly a forecast that includes significant revenue growth or projected margin expansion, management should be prepared to document how these improvements will be realized and how each specific management initiative is expected to drive the forecast. In such cases, it may be helpful to work with a valuation specialist to prepare a revenue and/or EBITDA bridge for the first few years of the forecast.

A valuation specialist can also help in supporting management's forecast by performing a detailed benchmarking analysis in which the company's PFI is compared to the forecasts of its public peers. When limited analyst data is available, a comparison to peer group historical financials may also be considered. This benchmarking analysis should be performed to support management's documentation around why the Entity's PFI assumptions are appropriate. This can include documentation of why the company's PFI is in-line with industry or have a detailed description of why it should differ.

Additional resources

For additional insight into PFI and other financial reporting valuation matters, be sure to check out these resources:

Analyzing Prospective Financial Information

Avoiding Pitfalls in Business Combinations

Goodwill Impairment Valuation Insights

Financial Reporting Valuations

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