Analyzing prospective financial information

Relevant guidance to consider

When preparing prospective finanical information (PFI), one must consider the various users of the PFI, including regulators. In recent years, scrutiny of PFI by both regulators and valuation specialists has been steadily increasing. As a result, preparers of PFI should understand the applicable standards. This document discusses some of the PFI guidance issued by the American Institute of Certified Public Accountants (AICPA), Securities and Exchange Commission (SEC), and valuation profession. Each is briefly described below.

The AICPA Guide on Prospective Financial Information[1]

Most recently published in 2021, the American Institute of Certified Public Accountants (AICPA) Guide on Prospective Financial Information was developed to assist management in the preparation of financial forecasts and projections. Further, the guide was intended to facilitate the completion of engagements by practitioners in accordance with Statements on Standards for Attestation Engagements and Statements on Standards for Accounting and Review Services. It is largely written from the perspective of audit or attestation services around the PFI (e.g., compilation, examination, agreed-upon procedures, etc.).

This guide also includes a number of important definitions pertaining to PFI. For example, it differentiates between *financial forecasts* (best guess under current conditions) and *financial projections* (uses one or more hypothetical[2] assumptions), but it confirms that both constitute PFI. PFI may be used in *prospective financial statements* (financial position, results of operations, and cash flows) or in a *partial presentation* (at least one missing key element[3]).

In addition, it provides the following guidance on developing PFI:

- PFI should be prepared:
  - In good faith;
  - With appropriate care by qualified personnel; and
  - Using appropriate accounting principles.

[1] https://future.aicpa.org/cpe-learning/publication/prospective-financial-information-guide

[2] An assumption used in a financial projection or in a partial presentation of projected information to present a condition or course of action that is not necessarily expected to occur, but is consistent with the purpose of the presentation.

[3] The required elements to be considered prospective financial information include the following: sales or gross revenues; gross profit or cost of sales; unusual or infrequently occurring items; provision for income taxes; income from continuing operations; discontinued operations or extraordinary items; net income; basic and diluted earnings per share; significant changes in financial position; a description of what the responsible party intends for the prospective financial statements to present, a statement that the assumptions are based on the responsible party's judgment at the time the prospective information was prepared, and a caveat that the prospective financial results may not be achieved; a summary of significant assumptions; and a summary of significant accounting policies.

- The process used to develop PFI should:
  - Provide the means to determine the relative effect of variations on the major underlying assumptions;
  - Provide adequate documentation of both the PFI and the process used to develop it;
  - Use information that is consistent with the plans of the entity;
  - Identify key factors as a basis for assumptions;
  - Use assumptions that are appropriate;
  - Seek out the best information that is reasonably available at the time;
  - Include, where appropriate, the regular comparison of the PFI with the attained results; and
  - Include adequate review and approval by the responsible party at the appropriate levels of authority.

SEC Division of Corporation Finance – Financial Reporting Manual[4]

Section 3520.2 of the Financial Reporting Manual states that all projections and forecasts must comply with the guidelines for projections in S-K 10, which requires that management have a reasonable basis for the assumptions underlying their prospective financial statements. Support for assumptions may include market surveys, general economic indicators, trends and patterns developed from the entity's operating history (e.g., historical sales trends), internal data and analyses (e.g., obligations under union contracts for labor rates), etc. An absence of adequate support may preclude a registrant's ability to include prospective financial statements in the filing. Additionally, a company with a limited operating history may not have a reasonable basis to present a financial forecast beyond one year.

Forecasts presented in lieu of pro forma financial statements must be presented in accordance with AICPA guidelines and the following guidance:

- Forecasts should cover a period of at least 12 months from the later of:
  - The latest historical balance sheet in the filing, or
  - The date of the event.
- Forecasts should include the same degree of detail as that required in pro forma data and should clearly set forth any assumptions used.
- Historical information of the registrant and business to be acquired (if applicable) should be presented for a recent 12-month period in parallel columns with the forecast.

Valuation standards – CEIV's mandatory performance framework

In response to concerns raised by the SEC and other capital market regulators over the quality, consistency, and transparency of valuations performed for financial reporting purposes, some of the largest valuation professional organizations[5] (VPOs) have developed the Certified in Entity and Intangible Valuations (CEIV) credential. The CEIV establishes a uniform set of standards and best practices to follow in the preparation of business entity and intangible asset fair value measurements.

CEIV holders are required to adhere to the credential's mandatory performance framework (MPF)[6] and Application of the MPF (AMPF)[7] documents, which provide guidance on the minimum scope of work and level of documentation required in valuation engagements. When performing valuations subject to the MPF, appraisers are expected to take a greater level of ownership over the PFI than was typical in the past. Valuation professionals will be responsible for evaluating whether PFI provided by management is representative of expected value and properly supported. In assessing the PFI, the CEIV's MPF and AMPF recommend the following procedures be performed:

- Comparison of PFI for an underlying asset of a subject entity to expected values of the entity cash flows;
- Assessment of the frequency of preparation;
- Comparison of prior forecasts with actual results;
- Performance of a mathematical and logic check;
- Comparison of entity PFI to historical trends;
- Comparison to industry expectations; and
- Check for internal consistency.

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[4] https://www.sec.gov/corpfin/cf-manual

[5] These VPOs include the AICPA, American Society of Appraisers, and Royal Institution of Chartered Surveyors.

[6] https://www.appraisers.org/docs/default-source/default-document-library/ceiv_mandatoryperformanceframework_0117.pdf?sfvrsn=538187d7_4

[7] https://www.appraisers.org/docs/default-source/default-document-library/ceiv_mandatoryperformanceframeworkapplication_0117.pdf?sfvrsn=268187d7_4

In addition, the CEIV credential holder is expected to document the following:

- The identification of the party or parties responsible for preparation of the PFI;
- The process used to develop the PFI from the perspective of market participants; and
- The explanation of key underlying assumptions used in the PFI, such as revenue forecasts, percentage of market share captured by the entity, or how the projected profit margins compare to those of market participants.

The level of documentation pertaining to PFI is expected to be more significant under the MPF than what many companies have experienced in the past. To meet these standards, valuation specialists may need to expand upon previous information requests and spend more time discussing the development and support of PFI with management. As these best practices are adopted more broadly by appraisers in their valuations, it is anticipated that many of these elements will also become more common in their review of fair value measurements.

Key observations

Given the increased scrutiny of PFI, it is more important than ever to have a robust and well-documented process for developing financial forecasts. In addition, to ensure the appropriate level of rigor is applied, one should be familiar with the PFI-related guidance discussed in this document. Companies with limited finance and FP&A resources available to test, modify, and document PFI may wish to involve an experienced valuation and business modeling specialist to help them through the process.

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Through our industry specialization, we understand the issues, value drivers, leading practices, and trends that shape the future of a particular industry, company, or business problem.

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