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<th>Title</th>
<th>Rhetoric and argument in financial reporting: disclosures in profit forecasts and takeover documents</th>
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<tr>
<td>Authors(s)</td>
<td>Brennan, Niamh; Gray, S. J.</td>
</tr>
<tr>
<td>Publication date</td>
<td>2000-06</td>
</tr>
<tr>
<td>Series</td>
<td>ACCA Occasional Research Papers; No. 31</td>
</tr>
<tr>
<td>Publisher</td>
<td>Association of Chartered Certified Accountants</td>
</tr>
<tr>
<td>Link to online version</td>
<td><a href="http://www2.accaglobal.com/pubs/general/activities/research/research_archive/orp-031-001.pdf">http://www2.accaglobal.com/pubs/general/activities/research/research_archive/orp-031-001.pdf</a></td>
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Rhetoric and Argument in Financial Reporting: Disclosures in Profit Forecasts and Takeover Documents

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and

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ACKNOWLEDGEMENTS

The Irish Accountancy Educational Trust is an independent charitable trust established by the Institute of Chartered Accountants in Ireland to promote and facilitate the development of accountancy. The authors gratefully acknowledge the generous financial support of The Irish Accountancy Educational Trust and the Commerce Faculty, University College Dublin.

KPMG Peat Marwick, London and Extel Financial Limited provided access to the data necessary to carry out this research.

We are grateful to Keith Warnock for his helpful discussions and insights on rhetoric and argument in financial reporting.
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Executive Summary

Despite the importance of profit forecasts to investors, little attention has been given so far to their publication, presentation and content.

The object of the paper is two-fold:

• Firstly, the paper examines disclosures in profit forecasts and in takeover documents from the perspective of rhetoric and argument to show how managements use accounting information to defend their own position and rebut the arguments of the other side. Persuasion in forecasts, and the verbal jousting and argument between bidder and target managements during contested bids, is considered.

• Secondly, the paper reproduces and discusses examples concerning disclosures in profit forecasts and in takeover documents. This is intended as useful precedent material for practitioners involved in preparing profit forecasts. The paper is supported by a more comprehensive set of examples available on the web (O/S insert web address).

This paper reviews financial reporting in profit forecasts, based on a systematic analysis of the disclosure practices in 250 profit forecasts disclosed during 701 public company takeover bids in the UK in the 5 year period 1988 to 1992. There were 74 examples selected from the 250 forecasts to illustrate particular practices which are commented on and discussed in the text. The examples shown do not necessarily illustrate best practice. It is intended that they highlight the wide variety of disclosure-related issues to be taken into consideration in preparing a forecast for publication. It is hoped these examples will act as useful precedent material to be consulted by practitioners involved in preparing profit forecasts for publication in the future.

In selecting material to reproduce, there was particular emphasis on disclosures used by management for rhetorical purposes – to persuade shareholders or to attack the other side in the bid.

The research showed that there was some evidence of strategic information disclosures by management both in the accounting practices employed in preparing forecasts, in the variability of levels of disclosure and the choice of wording used in some disclosures. In particular, the choice of disclosure practices by management may be used to provide protection if the forecast is not subsequently achieved, thus serving management’s own self-interest.
The following recommendations are made to improve reporting practices:

- Specification of minimum levels of disclosure in forecasts would reduce the flexibility in reporting practices which would result in greater consistency between companies in forecast items disclosed.

- The role of the reporting accountants and financial advisors should be expanded to require them to consider and report on the objectivity and consistency of disclosures in takeover documents.
1. Background to the Study

Introduction

Profit forecasts are often included in documents issued by companies listed on the Stock Exchange, even though there are no legal or Stock Exchange regulations requiring publication of such forecasts. Profit forecasts are frequently included in prospectuses by companies raising new capital or by companies during a takeover bid. Under stock exchange rules these forecasts must be reported on by both reporting accountants and the merchant bankers advising on the deal. The format of the forecasts is at the discretion of individual companies.

Although historical financial statements provide valuable information, they alone do not meet investors’ needs in today’s dynamic business environment. Potential investors are eager for insights into a company’s future performance. Investors recognise that future estimates from those most knowledgeable about the business are as valuable, if not more valuable, than historical results of the past.

Studies of users’ needs have shown forecast information to be one of the most important financial disclosures a company can make (see Courtis (1992) for a summary of this research). Given the perceived importance of future-orientated information, it is surprising that there has not been more research examining disclosure of forecasts and content of disclosures made therein.

The purpose of this paper is to discuss and analyse financial reporting practices relating to profit forecasts. Examples are examined from a comprehensive, in-depth survey of accounting practices and disclosures in profit forecasts in the UK during the five year period 1988 to 1992. Most importantly the paper examines disclosures in profit forecasts and in takeover documents from the perspective of rhetoric and argument to show how managements use accounting information to defend their own position and rebut the arguments of the other side. Persuasion in forecasts, and the verbal jousting and argument between bidder and target managements during contested bids, is considered.

Types of profit forecasts

Any wording that enables calculation of an approximate amount for future profits constitutes a forecast. A forecast need not be expressed in numerical amounts (e.g. ‘profit will be greater than last year’). A forecast made in advance of completion of financial statements for a period expired is referred to as an ‘estimate’.

Neither the Stock Exchange’s ‘Yellow Book’ (London Stock Exchange, 1997) nor the Takeover Panel’s City Code (Panel on Takeovers and Mergers, 1998) define the term ‘profit forecast’. If directors make a statement about prospects of the company, that
projection, even though not quantified, may be deemed a profit forecast if the company subsequently becomes involved in a takeover bid. A profit forecast may encompass published but unaudited profit figures (usually referred to as a profit ‘estimate’). Forecasts made with the publication of interim results may be treated as profit forecasts, and may have to be reported on if a bid is subsequently made.

All statements on earnings in takeover documents formally reported on by accountants/financial advisors as profit forecasts or profit estimates are treated as profit forecasts in this research.

**Circumstances in which forecasts are made public**

Although user surveys rank forecast information very highly, practice is for companies not to disclose such forecasts. Forecasts are rarely disclosed in the UK except in prospectuses, circulars and during takeover bids. Thus, most UK research into disclosure of profit forecasts is based on disclosures in prospectuses and circulars and in takeover documents.

Forecasts may be disclosed during takeover bids by bidder and/or target companies. Such forecasts may be included in offer documents issued by bidders or in defence documents issued by targets. Offer documents may include forecasts for bidders, targets or pro-forma forecasts for the combined entity should the takeover go ahead. Defence documents include target forecasts only.

Forecasts are normally made during takeover bids to support arguments being put forward by directors. Forecasts may be used by target company directors to show that shares are more valuable than the bid price or to show that the forecast profits justify their recommendation of the offer. Bidding company directors may wish to provide evidence in support of the value placed on shares offered as consideration for the acquisition. An unwelcome takeover bid is often resisted by financial rather than legal tactics. One important tactic is a statement by directors about future prospects and profits in documents sent to shareholders either by target or bidder companies.

The Companies Act, 1989 requires directors’ reports to include an indication of likely future developments in the business of the company. Such statements are generally vaguely worded. Forecasts are rarely disclosed in annual reports (Steele, 1982; Walsh and Horgan, 1990).

**Content of profit forecasts**

There are few regulations governing the content of profit forecasts. Forecasts published in prospectuses for new share issues and in takeover documents must be reported on by accountants and by the financial advisors to the transactions. Consequently, profit forecasts follow a fairly standard layout, but vary considerably in content and in the range of items and assumptions disclosed and in the level of detail disclosed. Thus, there is considerable variability in the disclosure practices followed in preparing these forecasts.
Rhetoric and argument in financial reporting

Takeover bids, financial disclosures in takeover documents, and, in particular, the competitive nature of contested takeover bids, provide a unique setting in which to study rhetoric and argument in financial reporting.

Aspects of interest include the verbal jousting between bidders and targets arguing about profit forecasts, and the way in which profit forecasts and disclosures in takeover documents are used persuasively to bring shareholders around to management’s point of view. A study of financial disclosures in this setting can add insights to our understanding of the ways in which management manipulate financial reporting to influence shareholders to support its strategies and goals.

To date there has been little research examining rhetoric and argument in accounting. Rhetoric is defined as ‘the art of using language so as to persuade or influence others; speech or writing expressed in terms calculated to persuade or impress (often in a depreciatory sense), language characterized by artificial or ostentatious expression’ (Oxford English Dictionary, 1989, p. 857). Covaleski, Dirsmith and Samuel (1995, p.26) comment that ‘…accounting is not only an instrument for representing an economic reality…but also a rhetorical device for setting forth…’. Thompson (1991) states that ‘the way theories are justified and legitimated becomes much more one of a debate, conversation or argument in which the attempt is to persuade an assumed sceptical audience. Hence the interest in rhetoric and in the protocols of argumentation.’

Arrington and Schweiker (1992) consider rhetoric and argument in the context of accounting research. The ‘art of argumentative persuasion’ – rhetoric – is necessary to convince colleagues, students etc. Rhetoric is seen to be, on the one hand persuasive, and, on the other hand, argumentative. Fogarty, Hussein and Ketz (1994) discuss rhetoric - the discourse employed in the process of persuasion – and recommend that it be applied to the study of the politics of accounting standards setting. Warnock (1992) examines the role of rhetoric and argument in the text of accounting standards, while Warnock (1997) analyses arguments and rhetoric in submissions from interested parties on documents published by standard setters on accounting for goodwill. He calls for further application of the principles of rhetoric and argumentation to be applied to financial reporting (Warnock, 1993).

Adelberg (1979) considers corporate reporting from the perspective of manipulating investor reactions. He found that non-standardised messages in annual reports were subject to management manipulation. Nelson, Megill and McCloskey (1987, p.16) state:

“There is no doubt in our minds that enterprising managers are focusing increasingly on their companies’ communication strategies – and that the use of rhetoric may well be frequently implicated in the implementation of such strategies. But who is ultimately served by the rhetorical nature of these strategies? In the case reviewed the entrepreneurs appeared to gain at the expense of the investors.”
Hooper and Pratt (1995) provide evidence of managers gaining at the expense of investors. In a case study of the New Zealand National Land Company they show how accounting rhetoric was used to obfuscate the dealings of European directors at the expense of local Maori shareholders.

The audience for the financial information reported in forecasts disclosed during takeovers is more complex than in routine reporting situations (such as annual reports). Profit forecasts are included in takeover documents (offer documents or defence documents) sent to shareholders. Therefore, shareholders are the primary audience for the information. However, in a contested bid, each party to the bid (i.e. the bidder / target) will be very conscious that management of the other party will also receive and carefully read the takeover documents.

The terms rhetoric and argument are used loosely in this research. Profit forecasts will be examined from the perspective of how persuasive and convincing are the disclosures by management. Profit forecasts are considered as a means of communicating a message. They may also be used to convey or imply a different message than the explicit communication in the forecast.

The plausibility and credibility of the language used and arguments offered are analysed. Disclosures in profit forecasts are considered from the perspective of their ability to persuade – the fairness and appropriateness of some of the techniques / methods of persuasion are considered. The arguments of the other side to the bid, and refutation of financial information reported in forecasts, is also examined.

**Structure of the Report**

This chapter has introduced the context in which profit forecasts are disclosed in the UK. The regulatory environment affecting disclosure of forecasts is summarised in chapter 2 that follows. The data on which the research is based, and the research methodology, is outlined in chapter 3. Chapters 4 and 5 and 6 contain the results of the study and discuss and analyse examples derived from a comprehensive, in-depth survey of accounting practices and disclosures in profit forecasts. Chapter 4 deals with the financial items disclosed in forecasts, chapter 5 covers the assumptions disclosed and chapter 6 examines other disclosures used for rhetorical purposes. These chapters contain examples of profit forecasts and of forecast-related material in takeover documents. It is intended that these examples will act as precedent material for practitioners involved in the preparation of profit forecasts. The final chapter, chapter 7, draws conclusions from the research results.
2. REGULATORY FRAMEWORK

Profit forecasts

A profit forecast may be included in offer or defence documents. If the bid is recommended or agreed by the board of the target company, the offer document will be prepared jointly by both parties to the bid. The offer document may include a profit forecast by the target, by the bidder or by both. If the bid is resisted by the board of the target, defence documents may include a profit forecast of the target.

Generally, the rules relating to publication of profit forecasts apply equally to the directors of a target company as to the directors of a bidding company.

Legal requirements

There are few legal regulations affecting disclosure of forecasts. The Financial Services Act, 1986 (Great Britain 1986) outlaws fraudulent or reckless forecasts. The Act also contains regulations to safeguard against misleading forecasts.

The legal system in the UK and Ireland is predominantly a common-law system which includes a large body of case law consisting of legal principles evolved through decisions of the higher courts over centuries. From a perusal of the standard company law texts, it is not clear what common-law duties there are requiring directors to disclose information.

Stock exchange requirements and City Code on Takeovers and Mergers

Under the continuing obligations of the listing rules, a company must notify the Company Announcements Office of ‘any information necessary to enable holders of its listed securities and the public to appraise the position of the company and avoid the creation of a false market in its listed securities.’ and of ‘any major new developments in its sphere of activity which are not public knowledge...’. Further clarification of this obligation is provided by The Stock Exchange which has published guidance notes on the dissemination of price sensitive information (International Stock Exchange of the United Kingdom and the Republic of Ireland Limited, 1995). General principle 4 of the City Code on Takeovers and Mergers requires that ‘Shareholders must be given sufficient information and advice to enable them to reach a properly informed decision and must have sufficient time to do so. No relevant information should be withheld from them.’ (Panel on Takeovers and Mergers, 1998).

The Stock Exchange’s Admission of Securities to Listing (the ‘Yellow Book’) (London Stock Exchange, 1997) regulates disclosures in prospectuses for new issues of shares and in connection with acquisitions, takeovers and mergers. These regulations were
amended in September 1997. Chapter 12, paragraphs 12.21 to 12.27 deal with profit forecasts. Except where an issuer has previously placed a profit forecast on public record, the Stock Exchange does not require publication of a profit forecast, but sets out certain regulations where a forecast is disclosed.

Any profit forecast or estimate of results published must be reported on by the auditors/reporting accountants and the financial advisors/sponsors. Section 12.24 requires that:

'A profit forecast or estimate...must be reported on by the auditors or reporting accountants... The accountants must report in the document their opinion as to whether:

(a) the forecast or estimate has been properly compiled on the basis stated; and
(b) the basis of accounting is consistent with the accounting policies of the issuer.'

Principal assumptions underlying forecasts must be stated. At the time this research was carried out, only those assumptions relating to matters outside the control of the directors, and which could have materially affected achievement of the forecast, were permitted to be disclosed. Changes to the Listing Rules introduced in September 1997 have now removed the prohibition on disclosure of ‘internal’ assumptions. Regulations now permit assumptions for each material factor to be included. The assumptions must clearly distinguish factors used in estimations for which the directors are responsible, and factors exclusively outside the influence or control of the directors.

The listing rules applying when this research was carried out gave no guidance on the financial amount to be forecast. The revised September 1997 regulations state that the forecast or estimate should normally be of profit before tax. Exceptional items and tax charges should be disclosed if they are expected to be abnormally high or low. If an amount other than profit before tax is presented, the reasons for so doing must be disclosed and clearly explained.

Profit ‘estimates’, which relate to a period expired, may only be subject to assumptions in exceptional circumstances. Dividend forecasts must be treated as profit forecasts where the issuer has a known policy of relating dividends to earnings, or where the dividend forecast otherwise implies a forecast of profit.

Where a company has made a profit forecast, and subsequently becomes aware that the outcome will be materially above or below the forecast amount, a further announcement concerning the forecast should be made (International Stock Exchange of the United Kingdom and the Republic of Ireland Limited, 1995). Stock exchange companies must give an explanation of any material differences between the trading results shown in the accounts and those given in any published forecast made by the company. A difference is usually regarded as material if it exceeds 10% of the forecast trading results. However, there may be circumstances (e.g. break even situations) where this or a greater percentage will not be considered material.
City Code on Takeovers and Mergers

The inclusion of profit forecasts in documents relating to takeovers is governed by the City Code on Takeovers and Mergers, which applies to takeovers of listed and unlisted public companies, but not to private companies. The Panel on Takeovers and Mergers, set up in 1968 by the Bank of England, interprets and enforces the Code.

The provisions of the City Code relating to publication of profit forecasts are set out in section K, Rule 28 of the Code. Rule 28.1 Standards of Care states: ‘There are obvious hazards attached to the forecasting of profits; this should in no way detract from the necessity of maintaining the highest standards of accuracy and fair presentation in all communications to shareholders in an offer’.

With one exception, the City Code does not compel directors to make a forecast. Except with the consent of the Panel (see rule 28.3 (e)), Rule 28.3 (d) states that profit forecasts made before the commencement of the offer period should be repeated in the offer document and reported on. Thus, some forecasts are included involuntarily in takeover documents because of rule 28.3 (d). The City Code also requires (Rule 28.6 (b)) profit ‘estimates’ (i.e. published estimates of financial performance for a period already expired) to be reported on in the same way as profit forecasts.

The City Code makes it clear that sole responsibility for forecasts rests with directors. Nonetheless, forecasts must be reported on by independent accountants and the company’s financial advisors.

Under the City Code, offers do not have to stay open for more than 21 days from the date of posting the offer document. This usually means the defending side has 10 to 14 days to issue a reply which may include a profit forecast. Thus, forecasts made by targets in contested bid situations are usually done under considerable time pressure. There is a danger that defending companies may delay their formal forecasts, while urging shareholders not to take action until they have seen them. This is contrary to the Code, which requires shareholders to have information in good time.

All forecasts are subject to an accountant’s report, with the exception of a forecast made by a bidder offering cash only (rule 28.3(a)). For forecasts made in all other takeover bids ‘...the accounting policies and calculations for the forecasts must be examined and reported on by the auditors or consultant accountants.’ The reports must be included in documents containing forecasts.

The reporting accountants must satisfy themselves that the forecast, so far as the accounting policies and calculations are concerned, has been properly compiled on the basis of assumptions made. The notes make clear that the reporting accountants are not responsible for the assumptions. However, accountants may advise on what assumptions should be disclosed and on their wording. Accountants should not allow unrealistic assumptions to be published nor important ones to be omitted.

Any financial advisor mentioned in the document must also report on the forecast. These reports must, under Rule 28.4, appear in the document containing the forecast, together with statements of consent from those making the reports.
The City Code also influences the content of forecasts. Under Rule 28.7, when a forecast of profit before taxation appears in a document to shareholders, forecasts of taxation, extraordinary items and minority interests must be included (where these are expected to be material). In relation to forecast periods where trading has commenced, Rule 28.8 requires that previously published profit amounts, which are available in respect of any expired portion of that trading period, together with comparable amounts for the preceding year, must be stated. A forecast of dividends is not normally considered to be a profit forecast, but will be where accompanied by an estimate of dividend cover.

Rule 28.2 states that any document in which the forecast appears must reproduce the assumptions, including commercial assumptions, on which the forecast has been based.

**Pronouncements of the accounting profession**

A miscellaneous technical statement on profit forecasts, *Accountants' reports on profit forecasts*, was issued in November 1978 which still applies (Institute of Chartered Accountants in England and Wales, 1978). This statement does not require an audit of profit forecasts and many reporting accountants emphasise this by including a paragraph in their report that an audit has not been performed.

In November 1990 an exposure draft of an auditing guideline was issued which was not progressed (Institute of Chartered Accountants in England and Wales, 1990). It provided detailed guidance on the work to be performed by accountants in reporting on forecast information.

**Conclusions**

This chapter summarised the regulatory context of this research by outlining the legal, institutional and professional regulations governing publication of profit forecasts in the UK. These regulations allow considerable flexibility and choice in the items, the assumptions and level of detail to be disclosed in relation to profit forecasts.
3. Data Sources

This chapter describes the data sources and data collection methods used to obtain the profit forecasts examined in this research.

Population and selection of sample

The sample chosen for study covers all takeover bids for companies listed on the London Stock Exchange during the 5 year period 1988 to 1992.

*Acquisitions Monthly* was used to obtain a list of all public company takeovers in the UK over the five year period of the study. The January edition of the journal publishes a summary of all UK public company takeovers completed and failed for the previous year.

In total, 705 completed and failed bids were listed for 1988 to 1992. Four bids listed have been excluded from the research. Two bids, occurring in late December, were included twice in two different years by *Acquisitions Monthly*. In one further case, the target had previously been taken over by a public company and was therefore a private company at the date of the second bid. No takeover documents were publicly available for this bid. The fourth bid excluded, although reported by *Acquisitions Monthly*, did not take place (this was confirmed in a telephone conversation with the bidder - an individual).

This study of forecast disclosure is comprehensive in that it includes the full population of 701 bids (involving 1,402 bidders and targets). No bids, bidders or targets have been excluded from the study other than those mentioned in the previous paragraph which are not properly part of the population.

Takeover bids are analysed by type in Table 3.1. There were 477 agreed bids, 209 contested bids (160 hostile bids, 49 competing bids (more than one bidder)) and 15 white knight bids. For the ensuing analysis, the 49 competing bids and 15 white knight bids are categorised as contested (i.e. 224 contested bids). Of the 209 contested bids, 103 failed (49%) (80 hostile bids and 23 competing bids). In addition, 15 agreed bids did not complete and three white knight bids were unsuccessful, resulting in a total of 121 failed bids in the study. The main reason why agreed bids did not complete is competing bids from other bidders.
Table 3.1: Analysis of UK listed company takeovers 1988 to 1992

<table>
<thead>
<tr>
<th>Completed bids</th>
<th>Failed bids</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agreed bid</td>
<td>462</td>
<td>15</td>
</tr>
<tr>
<td>Contested bid</td>
<td>106</td>
<td>103</td>
</tr>
<tr>
<td>White knight</td>
<td>12</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>580</td>
<td>121</td>
</tr>
</tbody>
</table>

**Data collection**

Forecasts were obtained from an examination of the takeover documents for the entire sample of 701 bids. These were obtained from three sources. Extel Financial’s microfiche service contains microfiche copies of all documents issued by companies quoted on the London Stock Exchange. Takeover documents are available on the C fiche service. This service was made available by KPMG Peat Marwick, London. Subsequently, Extel Financial allowed access to their hard copy and microfiche files to obtain documents not available from KPMG Peat Marwick. Finally, any remaining missing documents were obtained by writing directly to bidders, targets or their financial advisors.

**Frequency of forecast disclosure**

Frequency of forecast disclosure is shown in figures 3.1 and 3.2. Figure 3.1 shows that a forecast was disclosed in 197 out of 701 bids: a frequency of one forecast in every 3.5 bids. More than one forecast was disclosed in some bids.

Figure 3.2 shows that 226 firms (out of 1,402) disclosed a forecast: a frequency of one forecast for every six firms.

In all, 250 forecasts were disclosed.
Figure 3.1: Frequency of forecast disclosure in bids

- Successful and failed public company takeovers 1988 to 1992 per *Acquisitions Monthly*: 705
  - Bids excluded due to technical errors by *Acquisitions Monthly*: 701
  - Forecast not disclosed during takeover: 504
  - Forecast disclosed during takeover: 197

Figure 3.2: Frequency of forecast disclosure by bidders and targets

- Bidders and targets in the sample: 1,402
  - Forecast not disclosed during takeover: 1,176
    - Target company: 534 (Agreed: 456, Contested: 78)
    - Bidding company: 642 (Agreed: 504, Contested: 138)
  - Forecast disclosed during takeover: 226
    - Target company: 167 (Agreed: 86, Contested: 81)
    - Bidding company: 59 (Agreed: 38, Contested: 21)
Summary description of forecasts

The following characteristics of forecasts were analysed:
- Source;
- Location in the takeover documents;
- Forecast horizon;
- Period forecast;
- Quantification;
- Wording used.

Table 3.2 analyses the source of the forecasts. Location in the takeover document depended on whether the target or bidder made the forecast and on whether the bid was contested or not. Thus, all forecasts by target companies in contested bids were disclosed in defence documents.

In most cases, forecasts were disclosed in an appendix to the takeover document (either offer document, listing particulars (where shares were offered as consideration) or defence document). Occasionally they were in the body of the document (especially defence documents which do not follow as predictable a format as stock exchange documents).

Table 3.2: Source of forecasts

<table>
<thead>
<tr>
<th>Source</th>
<th>No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Offer document</td>
<td>82</td>
</tr>
<tr>
<td>Listing particulars</td>
<td>46</td>
</tr>
<tr>
<td>Offer document &amp; listing particulars</td>
<td>25</td>
</tr>
<tr>
<td>Defence document</td>
<td>91</td>
</tr>
<tr>
<td>Other</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>250</strong></td>
</tr>
</tbody>
</table>

Table 3.3 analyses forecast disclosure by forecast horizon and forecast period. The forecast horizon is the number of days between issuing the forecast and the forecast period end date. A substantial number of forecasts were published after the forecast period end. Only a few were published more than six months before the forecast period end. Thus, managements mainly use forecasts to communicate a message to shareholders when the disclosure context is favourable and the risk of getting the forecast wrong is reduced.

It is also debatable whether forecasts disclosed after the forecast period end provide much new information to the market. The act of appearing to supply investors with information may be more important than the actual provision of information. Publication of such post-period-end forecasts may be for public relations purposes.
Usually, the forecast was annual, although there were a number of half year forecasts. In one case, the forecast was for a five year period. The forecast period was significantly related to the forecast horizon. The longer the forecast horizon, the longer the period forecast.

As shown in table 3.4, most forecasts are quantified. Forecasts generally indicate a range of profits rather than a specific point forecast.

![Table 3.3: Forecasts analysed by forecast horizon and forecast period](image)

<table>
<thead>
<tr>
<th></th>
<th>6 Months or less</th>
<th>More than 6 months</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>After forecast period end</td>
<td>17 (68%)</td>
<td>64 (28%)</td>
<td>81 (32%)</td>
</tr>
<tr>
<td>Within 30 days</td>
<td>5 (20%)</td>
<td>36 (16%)</td>
<td>41 (17%)</td>
</tr>
<tr>
<td>31-90 days</td>
<td>3 (12%)</td>
<td>50 (22%)</td>
<td>53 (21%)</td>
</tr>
<tr>
<td>91-180 days</td>
<td>0 (0%)</td>
<td>53 (24%)</td>
<td>53 (21%)</td>
</tr>
<tr>
<td>&gt;180 days</td>
<td>0 (0%)</td>
<td>22 (10%)</td>
<td>22 (9%)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>25 (100%)</td>
<td>225 (100%)</td>
<td>250 (100%)</td>
</tr>
</tbody>
</table>

Range forecasts use wording such as ‘forecast profit in excess of £X’ or ‘forecast profit not less than £X’. The variety of wording in range forecasts is summarised in table 3.5. In all, eight alternative wordings were found in range forecasts.

The phraseology used in quantified forecasts appears to be carefully selected by managements, with small changes in wording considerably altering the message implicit in the forecast. For example, the phrase Profit will not be less than is upbeat and attempts to persuade shareholders of good performance by the firm. One must question, however, the similar but alternative wording Profit will be in excess of which is even more upbeat, while the phrase Profit will be at least is less optimistic. Thus small differences in wording can change the emphasis, altering perceptions of performance.

Managements also attempt to persuade shareholders of poor firm prospects – possibly to encourage them to accept the terms of the bid in the case of recommended offers. The most pessimistic wording is Loss will be greater than, followed by Profit is unlikely to reach and Profit will not exceed. Out of context, it is hard to know whether the phrase Loss will be not greater than is trying to communicate good or bad news.
Table 3.5: Wording used in range forecasts

<table>
<thead>
<tr>
<th>No.</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit will not be less than</td>
<td>111</td>
</tr>
<tr>
<td>Profit will be in the region of</td>
<td>10</td>
</tr>
<tr>
<td>Profit will be in excess of</td>
<td>11</td>
</tr>
<tr>
<td>Profit is unlikely to reach</td>
<td>3</td>
</tr>
<tr>
<td>Profit will be at least</td>
<td>2</td>
</tr>
<tr>
<td>Profit will not exceed</td>
<td>2</td>
</tr>
<tr>
<td>Loss will be not greater than</td>
<td>8</td>
</tr>
<tr>
<td>Loss will be greater than</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>148</strong></td>
</tr>
</tbody>
</table>

Table 3.6 summarises the wording used in non-quantified forecasts. Some wordings attempt to persuade readers of good news while other forecasts are clearly bad news forecasts. Small variations in wording change the emphasis as in *Profit less than previous period* which is similar to (but more pessimistic than?) *Profit not greater than previous period*. A variety of wordings are used to communicate better prospects as in *Continued further growth, Improvements in profit, Profit greater than previous period* and *Return to profit*. Careful consideration of these wordings is required. For example, which is better *Continued further growth* vs. *Improvements in profit* or *Improvements in profit* vs. *Profit greater than previous period*?

Table 3.6: Wording used in non-quantified forecasts

<table>
<thead>
<tr>
<th>No.</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit less than previous period</td>
<td>5</td>
</tr>
<tr>
<td>Profit greater than previous period</td>
<td>15</td>
</tr>
<tr>
<td>Profit not greater than previous period</td>
<td>1</td>
</tr>
<tr>
<td>Profit not different from previous period</td>
<td>1</td>
</tr>
<tr>
<td>Continued further growth</td>
<td>3</td>
</tr>
<tr>
<td>Loss forecast</td>
<td>9</td>
</tr>
<tr>
<td>Improvements in profit</td>
<td>1</td>
</tr>
<tr>
<td>Profit in line with stock market expectations</td>
<td>2</td>
</tr>
<tr>
<td>Return to profit</td>
<td>3</td>
</tr>
<tr>
<td>Wording not stated</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>41</strong></td>
</tr>
</tbody>
</table>

Of the 41 non-quantified forecasts, 15 forecast poorer results than the previous period, 22 forecast better results and three forecast results not different from/in line with expectations. Most non-quantified forecasts (23 - 56%) are made involuntarily under the rules of the Takeover Code.

**Examples of disclosures in forecasts**

A comprehensive content analysis of all forecasts (whether voluntary or involuntary/repeat forecasts) was carried out. Disclosures in the forecasts were measured using a counting method. Results analysing the association between levels
of disclosure and company and takeover variables are reported in Brennan and Gray (1998). This paper uses examples from the 250 forecasts collected to illustrate the variety of disclosures in profit forecasts and in takeover documents. This material shows the wide range of disclosure practices adopted in profit forecasts, the detailed content of which is largely unregulated. There are 74 examples provided to act as precedent material for practitioners involved in the preparation of forecasts. The examples shown do not necessarily illustrate best practice. It is intended that they highlight the wide variety of disclosure-related issues to be taken into consideration in preparing a forecast for publication.

In selecting material to reproduce, there was particular emphasis on material that was used by management for rhetorical purposes – to persuade shareholders or to attack the other side in the bid.

The full examples are provided, with full details of sources, in the web site supporting this paper (O/S insert web address). The examples are presented alphabetically, by name of forecasting company. Each full example in the supporting web site is numbered. The extracts reproduced in chapters 4, 5 and 6 of this report are cross-referenced by example number to the examples in the supporting web site.

**Summary and conclusions**

This chapter described the population, sample and data sources used to obtain the forecasts for this research study. Basic descriptive statistics are provided on the population sample and to describe the forecasts.
4. Profit forecasts

Forecasts have no effect *per se* as the underlying facts about companies are unchanged by forecasts. Forecasts only disclose those facts and are a reflection of the underlying facts about companies which are not previously known. Thus, forecasts may correct perceptions, but do not change the underlying facts about the company.

The public relations ‘headline news’ value of forecasts may be most persuasive rather than the detailed information disclosed. The sentiment being communicated rather than the specific detailed information in the forecast may be most important.

Extracts from profit forecasts are presented and discussed in this chapter. These extracts are shown more completely, with full details of sources, in the web site supporting this paper (O/S insert web address). The examples are presented alphabetically, by name of forecasting company. Each full example in the supporting web site is numbered. The examples reproduced in this report are cross-referenced by example number to the examples in the supporting web site.

Discussion of the extracts is organised under seven headings: (i) Circumstances in which forecasts are disclosed; (ii) Methods of presentation of forecasts; (iii) Items disclosed in profit forecasts; (iv) Wording in forecasts; (v) Accounting policies disclosed; (vi) Bases of forecasts; and (vii) Notes to forecasts.

Disclosure of information privately is then discussed and the chapter concludes by providing examples of items forecast which were not formally reported on by the reporting accountants or financial advisors to the company.

**Circumstances of disclosing forecasts**

As has been discussed in chapter 2, forecasts are generally disclosed voluntarily. However, in some circumstances forecasts are disclosed involuntarily because of statements construed as profit forecasts made before the takeover bid. Such statements must be reported on as profit forecasts.

In this paper, forecasts have been divided into three categories depending on the circumstances leading to making the forecast: voluntary, involuntarily and repeat forecasts. Table 4.1 shows that most forecasts were made voluntarily.
The majority of forecasts (210 out of 250) were made voluntarily. There were 27 forecasts made involuntarily under the rules of the Takeover Code - statements made prior to bids by companies which have to be formally reported on as a forecast. There were 13 forecasts which were repeats of forecasts made in previous bids.

Barlo (example 6) made a forecast under these circumstances. The wording used makes it clear that the forecast is being made reluctantly.

A statement on current trading issued on 10th February, 1992 by the Group included the following statement:

"On the basis of current performance trends, the Group is budgeting, in the absence of unforeseen circumstances, for further growth in revenues and profitability in 1992/1993 financial year".

As the above statement, which the Directors confirm is still valid, constitutes a profit forecast under the Code, please refer to the reports set out on page 16.

The involuntary nature of the disclosure influences the content of the forecast. Typically, these forecasts disclose little detail about profitability but include extensive assumptions. For example, Corton Beach’s (example 17) involuntary forecast was not quantified (‘earnings during the current financial year would show a further increase’). Illustrating management’s nervousness in making the involuntary forecast, the forecast included 12 assumptions:

In the Wall Street Journal of 24th September, 1991, an article appeared in which the Finance Director of LASMO was quoted in terms which might be construed as a forecast. The prior statement is not repeated and the explanation / justification provided for not making a forecast is not very persuasive.

Conversely, LASMO (example 43) included a note in its listing particulars that a statement made prior to the bid should not be construed as a forecast. The prior statement is not repeated and the explanation / justification provided for not making a forecast is not very persuasive.

In the Wall Street Journal of 24th September, 1991, an article appeared in which the Finance Director of LASMO was quoted in terms which might be construed as a

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1 The methodology for counting items and assumptions in forecasts is described in Brennan and Gray (1998). There are apparently six assumptions (a to f) listed in Corton Beach’s forecast (example 17). However, there are three assumptions in (c) – dealing with (i) industrial disputes, (ii) direct disruptions to the business and (iii) indirect disruptions through suppliers and customers. There are five assumptions in (d) – dealing with (i) economic costs, (ii) inflation, (iii) interest, (iv) tax and (v) exchange rates. Thus, in total there are 12 assumptions in this example.
forecast as to the likely level of profits for LASMO for the year ending 31st December, 1991. The Finance Director had no intention of making any such forecast and no such forecast should be inferred from that article. The Board’s views on current trading are set out above.

In the case of companies subject to more than one bid, a forecast made in an earlier bid may be repeated in a subsequent bid. There were 13 such forecasts in the sample. Irish Distillers (example 40) made such a repeat forecast:

In the document from the Chairman of Irish Distillers to Irish Distillers shareholders dated 7th July 1988, the Directors of Irish Distillers forecast that, in the absence of unforeseen circumstances, profit before taxation and earnings per share for the year ending 30th September 1988 would be in excess of IR£18 million and IR£23.4p respectively.

The Directors of Irish Distillers confirm that the forecasts remain valid for the purpose of the Offer and that Stokes Kennedy Crowley (Chartered Accountants and auditors to the Irish Distillers Group), County NatWest Limited and The Investment Bank of Ireland Limited, who reported on the forecasts, have each indicated that they have no objection to their reports continuing to apply.

Sketchley (example 63) disclosed a forecast in defending a bid from Godfrey Davis. The forecast was repeated (example 64) in defending a subsequent bid from Compass Group. Note that because the forecast year end had passed, the forecast is referred to as an ‘estimate’. The estimate is comprehensive with a forecast of eight items and which included five assumptions (see full example, O/S web site address).

In the defence document dated 1st March, 1990 your Board made a profit forecast for the current financial year. The year end has now passed and the Board can confirm that it estimates the same level of profits as previously forecast. Details relating to the estimates are set out in Appendix I.

The choice of wording in the above two repeat forecasts is slightly different. Sketchley’s board confirms the forecast even after completion of the period forecast, while the directors of Irish Distillers are not as certain when they state that the forecasts remain valid for the purpose of the offer (does this imply that the Irish Distillers’ forecast would not be valid for other purposes?).

**Methods of presenting forecasts**

The method of forecast presentation varies, from brief narrative descriptions to quite detailed financial accounts. Steetley’s forecast (example 65) was in narrative format.

The Directors of Steetley estimate that, on the basis set out in paragraph 2 below, the profit before taxation of Steetley and its subsidiary and associated undertakings (the "Group") for the year ended 31st December, 1991 was £32.5 million and earnings per share were 12.9p. Extraordinary charges of approximately £15.1 million are estimated. These comprise approximately £8.0 million in respect of defence costs associated with the Redland bid and approximately £7.1 million (net of tax) in respect of withdrawal from the bulk magnesia refractory segment and closure of related process lines.

Reed International’s (example 55) forecast included a detailed profit and loss account. In total, nine items were forecast.
The Directors of Reed forecast that, in the absence of unforeseen circumstances and on the bases and assumptions set out below, the consolidated profit before tax and earnings per share of Reed for the 12 months ending 31 December 1992 will be not less than £239 million and 30.1p respectively. An illustrative summarised profit and loss account based on these forecasts together with comparative unaudited restated figures for the 12 months ended 31 December 1991, based on management accounting information, is set out below:

<table>
<thead>
<tr>
<th></th>
<th>Restated 12 months ended 31 December 1991</th>
<th>Forecast 12 months ending 31 December 1992</th>
<th>Change %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover £ million</td>
<td>1,578</td>
<td>1,665</td>
<td>6%</td>
</tr>
<tr>
<td>Operating profit</td>
<td>226</td>
<td>281</td>
<td>24%</td>
</tr>
<tr>
<td>Net interest expense</td>
<td>(36)</td>
<td>(42)</td>
<td>17%</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>190</td>
<td>239</td>
<td>26%</td>
</tr>
<tr>
<td>Tax</td>
<td>(55)</td>
<td>(70)</td>
<td>27%</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>135</td>
<td>169</td>
<td>25%</td>
</tr>
<tr>
<td>Minority interests and preference dividends</td>
<td>-</td>
<td>(1)</td>
<td>-</td>
</tr>
<tr>
<td>Profit attributable to ordinary shareholders before extraordinary items</td>
<td>135</td>
<td>168</td>
<td>24%</td>
</tr>
<tr>
<td>Earnings per ordinary share 24.3p</td>
<td>30.1p</td>
<td>24%</td>
<td></td>
</tr>
</tbody>
</table>

A major factor explaining the forecast of a 26 per cent. increase in profit before tax for the 12 months to 31 December 1992 is the stronger first quarter performance, where comparison is made against a prior year which was impacted by the Gulf War and higher restructuring costs. The SSAP 24 net pension credit reflected in the 1992 forecast is £27.6 million (1991: £23.9 million).

The choice of method of presentation is likely to have a considerable impact on the usefulness of the forecast for the purposes of rhetoric and argument. The detail in Reed’s forecast, and its layout as a financial statement, makes it appear more reliable. However, in substance (as shown in Table 4.1), both Steetley’s and Reed’s forecasts contain a similar level of information (profit before tax and earnings per share).

<table>
<thead>
<tr>
<th>Items forecast</th>
<th>Steetley</th>
<th>Reed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Operating profit</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Tax</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Extraordinary item</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Minority interests</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Earnings per share</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

One could argue that Steetley’s forecast is more reliable as it includes extraordinary items. Reed’s forecast refers to extraordinary items (Profit attributable to ordinary shareholders before extraordinary items) and this must raise a question as to why extraordinary items are not included in the forecast. The explanation at the end of Reed’s forecast for the 26 per cent increase in profits suggests that management anticipate that the forecast will be attacked by the other side. It is worth noting that
Reed management has drawn readers’ attention to the most advantageous, highest percentage increase in the forecast (i.e. 26%).

**Items disclosed in forecasts**

Rowntree’s forecast (example 58) was one of the most detailed in the study, with 20 items forecast and eight assumptions disclosed therein. Few profit forecasts disclosed as much detail in the forecast profit and loss account, let alone provide detailed notes to the forecast. This detail is particularly commendable given the length of time between the forecast (26/5/1988) and the forecast period end (31/12/1988). This level of disclosure is likely to make the forecast appear more reliable to readers and to enhance the message underlying the forecast.

**Profit forecast**

The detail supporting the forecast set out on page 1 is as follows:-

<table>
<thead>
<tr>
<th>Notes</th>
<th>Forecast 1988 £m</th>
<th>Actual 1987 £m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover of continuing businesses (i)</td>
<td>1,295.2</td>
<td>1,235.8</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(674.2)</td>
<td>(662.2)</td>
</tr>
<tr>
<td>Gross margin</td>
<td>621.0</td>
<td>573.6</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>(138.9)</td>
<td>(128.6)</td>
</tr>
<tr>
<td>Fixed overheads</td>
<td>(344.2)</td>
<td>(329.4)</td>
</tr>
<tr>
<td>Trading profit of continuing businesses (i)</td>
<td>137.9</td>
<td>115.6</td>
</tr>
<tr>
<td>Trading profit of snack food businesses (ii)</td>
<td>5.6</td>
<td>14.5</td>
</tr>
<tr>
<td>Profit on ordinary activities before taxation</td>
<td>135.0</td>
<td>112.1</td>
</tr>
<tr>
<td>Taxation (iii)</td>
<td>(30.8)</td>
<td>(24.2)</td>
</tr>
<tr>
<td>Profit on ordinary activities after taxation</td>
<td>104.2</td>
<td>87.9</td>
</tr>
<tr>
<td>Extraordinary items (iv)</td>
<td>17.5</td>
<td></td>
</tr>
<tr>
<td>Retained profit</td>
<td>121.7</td>
<td>87.9</td>
</tr>
<tr>
<td>Earnings per share (v)</td>
<td>47.0p</td>
<td>40.8p</td>
</tr>
<tr>
<td>Dividends per share</td>
<td>18.5p</td>
<td>15.5p</td>
</tr>
</tbody>
</table>

Dixons Group (example 20) also presented a very comprehensive forecast. The forecast is in narrative format and two items are forecast – profit before tax and earnings per share. The forecast is accompanied by a divisional analysis and by 11 notes. Careful study of the detail in these notes is required to fully understand the forecast. Also, some doubt must be cast on the forecast as it is accompanied by 15 assumptions (Rowntree’s forecast only included eight assumptions). Results in Brennan and Gray (1998) indicate that five assumptions were the average number disclosed per forecast. It would seem that these assumptions give the company plenty

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2 According to the methodology in Brennan and Gray (1998), Rowntree has disclosed 15 items on the face of the profit and loss account which is accompanied by five notes, making 20 items disclosed in total.

3 According to the methodology in Brennan and Gray (1998), Rowntree has disclosed three general assumptions and four additional assumptions. However, assumption (iii) in the forecast contains two assumptions – one dealing with industrial disputes in the firm, and one dealing with industrial disputes in suppliers, making a total of eight assumptions.

4 Dixons lists five assumptions: (1) contains four assumptions (composition of the group, composition of management, commercial policies, accounting policies); (2) contains four assumptions (interest rates, exchange rates, inflation rates, economy); (3) contains four assumptions (rates of tax, legislative changes, political changes, competitive environment); (4) contains two assumptions (abnormal weather, industrial disputes) and (5) contains one assumption – 15 assumptions in total.
of potential excuses if the forecast is subsequently not met. Sophisticated (institutional) shareholders should appreciate the implications for the reliability of the forecast of so many assumptions but the inclusion of so many assumptions suggests the contrary.

1. PROFIT FORECAST
The Directors of Dixons Group plc forecast that, in the absence of unforeseen circumstances and on the bases and assumptions set out below, profit on ordinary activities before tax of the Group for the 52 weeks ending 28 April 1990 will be not less than £70 million and earnings per share will be not less than 11 pence.

F. Copson Group’s forecast (example 25) is unusual in that it disclosed considerable detail (13 items\(^5\)) but no assumptions. Users of forecasts have expressed a preference for no assumptions because assumptions reduce the certainty of a forecast being achieved (Brennan, 1998).

1. Estimate of results
The Board of Copson estimates that, in the absence of unforeseen circumstances and on the basis set out below, the loss on ordinary activities before taxation, the exceptional items taxation and the extraordinary item for the financial year ended 30th April, 1991 were as follows:

<table>
<thead>
<tr>
<th>Notes</th>
<th>£’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit on ordinary activities before taxation and exceptional item:</td>
<td></td>
</tr>
<tr>
<td>hotels and nursing homes</td>
<td>376</td>
</tr>
<tr>
<td>builders’ merchants</td>
<td>-</td>
</tr>
<tr>
<td>Exceptional item</td>
<td>(2,332)</td>
</tr>
<tr>
<td>Loss on ordinary activities before taxation</td>
<td>(1,956)</td>
</tr>
<tr>
<td>Taxation</td>
<td>(129)</td>
</tr>
<tr>
<td>Loss on ordinary activities after taxation</td>
<td>(2,085)</td>
</tr>
<tr>
<td>Extraordinary item</td>
<td>(1,214)</td>
</tr>
<tr>
<td>Retained Loss</td>
<td>(3,299)</td>
</tr>
<tr>
<td>Loss per share</td>
<td>17.9p</td>
</tr>
</tbody>
</table>

Notes:
(a) The exceptional charge of £2,332,000 represents the deficit arising on revaluation of certain of the Group’s properties, further details of which are set out in Appendix V.
(b) The taxation charge of £129,000 represents the write-off of irrecoverable Advance Corporation Tax.
(c) The extraordinary charge of £1,214,000 represents additional losses on disposal and closure costs of the Group’s builders’ merchants activities.
(d) The loss per share has been calculated by dividing the loss on ordinary activities after taxation of £2,085,000 by the weighed average number of Ordinary Shares in issue during the year of 11,653,000.

There were a number of instances of companies disclosing more than one forecast. Ward White disclosed a forecast on 19/7/1989 (example 71) and an estimate on 12/8/1989 (example 72). The forecasts were £33 million and £34.1 million profit before tax and 11.8p and 12.2p fully diluted earnings per share. The first forecast

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\(^5\) There are nine items identified on the face of the profit and loss account and four notes thereon, making a total of 13 items disclosed.
disclosed five items\(^6\) and 13 assumptions\(^7\). The second ‘estimate’ included more items but fewer assumptions (18 items\(^8\), three assumptions\(^9\)). The influence on the second forecast of rhetoric and argument by the other side is evidenced by the inclusion of a segmental analysis ‘in response to criticism’. It is possible that the reduction in number of assumptions from 13 to three may also have been in response to comments made on the forecast by the other side (or possibly by financial commentators in the press).

Elsevier and Reed, unusually, presented a forecast of the combined results for Reed Elsevier (example 56) (‘pro forma’ forecast) as well as individual forecasts for each company – Reed (example 55) shown earlier and Elsevier (example 22) shown further on in this chapter. The inclusion of such a pro-forma forecast is likely to improve the persuasiveness of the individual forecasts of Elsevier and Reed and thus assist in getting shareholder agreement to the merger.

**Financial strength**

Reed Elsevier will be one of the world's largest publishing and information groups. Its scale and financial strength will create a sound basis for the development of new products and penetration into new markets.

<table>
<thead>
<tr>
<th>Pro forma aggregate figures</th>
<th>£ million</th>
<th>Dfl million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market capitalisation at 28 October 1992</td>
<td>5,872</td>
<td>16,089</td>
</tr>
<tr>
<td>12 months ending 31 December 1992</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forecast Turnover</td>
<td>2,455</td>
<td>7,660</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>430</td>
<td>1,340</td>
</tr>
<tr>
<td>Interest cover</td>
<td>16x</td>
<td></td>
</tr>
</tbody>
</table>

Combined summarised pro forma financial information concerning the merged group and details of its basis of preparation are set out in Appendix 1.

**Wording in forecasts**

Previous researchers have had problems in interpreting the forecast amounts (Dev, 1973; Ferris, 1975; Morris and Breakwell, 1975; Platt, 1979; Hartnett, 1990). In some cases, they found that it was not clear which figure of profit was being forecast (normal trading profit, net profit before tax, before or after minority interest, before or after extraordinary items). Phrases used such as ‘profits of the group’ and ‘normal trading profit’ were not clear. Other ambiguities were found, such as whether depreciation was calculated on current or historic values (this research was carried out prior to the publication of FRS 3), and how exceptional and non-recurring items were treated in arriving at forecast profit.

\(^6\) There are three items forecast – profit before tax, earnings per share and the tax charge. In addition there are two accounting notes to the forecast (notes (iii) and (iv)), making a total of five items disclosed.

\(^7\) Ward White lists three assumptions in example 71: (i) contains four assumptions (composition of the group, composition of management, commercial policies, trading policies); (ii) contains five assumptions (customers and suppliers, industrial action, political developments, Government action, changed in taxation) and (iii) contains four assumptions (interest rates, exchange rates, retail demand, inflation), making a total of 13 assumptions.

\(^8\) There are 14 items forecast on the face of the profit and loss account which, together with the segmental analysis note and notes (c), (d) and (f), make up 18 items disclosed.

\(^9\) Three assumptions are disclosed – tax (e), deferred tax (e) and exclusion of the costs of the offer (f).
It is likely that management are deliberately vague on the specific amount being forecast and select the amount that portrays the firm in the best light. Such vagueness may also provide management with excuses in the event the forecast is not achieved.

This problem is less likely in this research as the City Code was amended in 1984/85 to require disclosure of forecasts of taxation, extraordinary items and minority interests, where these are expected to be significant. Xtra-vision (example 74) forecast a ‘loss’ as follows:

The Board of Xtra-vision is currently forecasting a loss for the year ending 31 January 1991.

Cambridge’s forecast (example 9) refers to ‘profits’ without indicating whether these are operating profits, before or after tax, etc.

For the year ending 28 February 1991, the Directors of Cambridge forecast that, in the absence of unforeseen circumstances, the level of profits for the second half of the year, as arrived at below, will be higher than that reported for the first half.

**Accounting policies disclosed**

The Stock Exchange’s ‘Yellow book’ requires the reporting accountants to state that the profit forecast is presented on a basis consistent with the accounting policies of the company or group in question.

Note 1(c) of Rule 28.2 of the City Code on Takeovers and Mergers states that the reporting accountants must satisfy themselves that the forecast, so far as accounting policies and calculations are concerned, has been properly compiled on the basis of the assumptions made. Most forecasts state that consistent accounting policies are followed.

However, the regulations do not prohibit management from changing accounting policies provided the change is disclosed. In some cases, managements have selected income-enhancing changes in order to present as good forecasts as possible. For example, Dixons’ (example 20) forecast profits benefited from a number of changes in methods of accounting. Note (1) shows that the company changed its accounting policy for pensions but did not restate the previous year’s results. This change is justified as arising from implementation of a new standard. In addition, note (7) discloses the release of £10 million which has the effect of increasing forecast profits. The change is justified as following an independent actuarial review. It illustrates just how much firms can have available by way of ‘war-chest’ in times of need.

3. **NOTES (extract)**
(1) The Group is implementing SSAP 24 in the accounts for the year ending 28 April 1990. Willis Consulting Limited, the actuaries of the Group’s UK pension scheme, have advised that there was a surplus on the scheme of £49 million as at 6 April 1989, and amortisation of the pension surplus in accordance with SSAP 24 over the average remaining service period of current employees would result in a potential credit to profit in respect of UK pensions of £7.0 million; the regular pension cost would have been £3.3 million. The Directors are, however, limiting the amount of the potential credit recognised in the current year by reducing the UK pension charge to nil.

(7) The profit before tax of Retail Financial Services includes £10 million arising from the release of surplus provisions in respect of extended warranty policies in force as at 29 April 1989 following an independent actuarial review. This review has shown a total surplus of £30 million. If claims experience remains as currently projected, the balance of the surplus of £20 million will be considered for release to profit in the years 1990/91 and 1991/92).

Irish Distillers (example 41) changed its accounting policy, to capitalise interest for the first time. This change also has the effect of increasing profits. The directors make no effort to justify the change or explain why it is being made coincident with the forecast.

The accounting policies adopted in preparing the forecasts are consistent with those normally adopted by the Group, as set out in the audited accounts for the year ended 30th September, 1987, other than a change in accounting policy to include interest on designated loans in maturing whiskey stocks.

Maturing whiskey stocks at 30th September, 1988 will be valued on the basis adopted hitherto but, instead of excluding all interest from overheads, interest on designated loans directly related to maturing whiskey stocks will be attributed to those stocks that are within their normal maturation period. On the previous basis, the profit before taxation and earnings per share now forecast would have been lower by IRE848,000 and 1.21p respectively. For the year ended 30th September, 1987, the profit before taxation on the new basis would not have differed materially from the published figure.

Magnet (example 45) changed its accounting policy for depreciation to the benefit of forecast profits even though the bid was not contested. No justification for choosing to make the change at the time of the forecast is provided.

The estimate has been prepared on the basis of the accounting policies consistently adopted by Magnet, save that the Magnet Group has discontinued the provision of depreciation of freehold and long leasehold buildings, it being the Magnet Group's policy to maintain them in such condition that the estimated residual values are at least equal to the net book values in the accounts. The charge under the previous policy for the year to 1st April, 1989 would have been approximately £250,000.

The Group has continued its policy of deferring certain store opening expenses and is amortising these costs over two years. A formal accounting policy for this procedure will be defined in the accounts to 1st April, 1989.

However, some companies provide persuasive explanation justifying a change in accounting policy. Highland Electronics (example 33) changed its accounting policy, not to fight off the bid, but to be consistent with policies adopted by the bidder, Arlen. It should be noted that this change in accounting policy reduced forecast profits.
In preparing the financial information on the Highland Group in Part V of these Listing Particulars and the estimates of the Highland Group’s profit before taxation and of extraordinary charges for the year ended 30th April 1990, the same accounting policies have been used as those normally adopted in the preparation of the statutory accounts of the Highland Group save that, in order to bring the principal accounting policies into line with those of the Arlen Group, the accounting policy of the Highland Group relating to research and development expenditure has been changed so as to write off development expenditure as incurred. Consequently, development expenditure of approximately £121,000 incurred during the year ended 30th April 1990 has been written off to the profit and loss account in arriving at the Highland Group’s estimated profit before taxation for that year.

Elsevier (example 22), a Dutch company, stated that the accounting policies normally followed by the company were adjusted to convert Dutch generally accepted accounting principles (GAAP) to UK GAAP.

The forecasts of consolidated profit before tax and earnings per share have been prepared using accounting policies normally adopted by Elsevier, as adjusted to conform with presentation under U.K. GAAP. They are based upon the published unaudited interim results for the six months ended 30 June 1992, the results shown by unaudited management accounts for the three months ended 30 September 1992 and forecasts for the three months ending 31 December 1992.

The restatement of Elsevier’s profit after tax from Dutch GAAP to U.K. GAAP for the two years ending 31 December 1992 is shown below:

<table>
<thead>
<tr>
<th></th>
<th>1991</th>
<th>1992</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit after tax</td>
<td>Dfl million</td>
<td>Dfl million</td>
</tr>
<tr>
<td>under Dutch GAAP</td>
<td>380</td>
<td>442</td>
</tr>
<tr>
<td>as shown in Appendix</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2, section B (1991</td>
<td></td>
<td></td>
</tr>
<tr>
<td>only)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reclassification of</td>
<td>(12)</td>
<td>(14)</td>
</tr>
<tr>
<td>extraordinary items</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit after tax</td>
<td>368</td>
<td>428</td>
</tr>
<tr>
<td>under U.K. GAAP</td>
<td></td>
<td></td>
</tr>
<tr>
<td>as shown above</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Telephone Rentals (example 66) used merger accounting, rather than the more usual acquisition accounting, to include the results of a newly acquired subsidiary. Group profits were adjusted upwards as a consequence.

1. Profit forecast (extract)

The results of Sound Systems plc, acquired on 29th July 1988, have been accounted for on a merger accounting basis.

Notes: (extract)

(g) The graphs on pages 2 and 3 of this document have been derived from the published accounts of Telephone Rentals, together with the profit and dividend forecasts contained in this document.

The group pre-tax profit figures for 1985, 1986 and 1987 have been restated to reflect the consolidation of Sound Systems plc on a merger accounting basis, as follows:

<table>
<thead>
<tr>
<th></th>
<th>1985 (£000s)</th>
<th>1986 (£000s)</th>
<th>1987 (£000s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>As originally published</td>
<td>15,659</td>
<td>17,236</td>
<td>19,626</td>
</tr>
<tr>
<td>As adjusted</td>
<td>15,915</td>
<td>17,391</td>
<td>19,902</td>
</tr>
</tbody>
</table>

There is no effect on reported earnings per share in respect of 1986 and 1987.
Bases of forecasts

Many forecasts such as Xtra-vision (example 74) disclose the basis on which the forecast is made. Other examples referring to the basis of the forecast include examples 9, 11, 17, 20, 33, 34, 45, 58, 63, 64, and 71 (see full examples in O/S website address).

2. Bases of calculation

The forecast has been made by reference to:
(a) interim results for the six months to 31 July 1990;
(b) management accounts for the period to 30 September 1990; and
(c) forecasts for the remaining four months of the financial year.

The accounting policies underlying the forecast are consistent with those normally adopted by Xtra-vision, as set out in the audited accounts for the year ended 31 January 1990.

Notes to forecasts

As stated earlier, more detail in forecasts enhances their reliability and persuasiveness. The detail is often disclosed in a note to the forecast. Conversely, as also seen earlier, notes include important information to which the reader may not pay sufficient attention. Relegating significant disclosures to notes may downplay their importance in the perceptions of shareholders.

Rowntree’s (example 58) profit and loss account was accompanied by five notes to the accounts. The segmental analysis of both turnover and trading profit in note (1) is an example of good disclosure. Note (2) analyses profit between continuing businesses and discontinued businesses - this is now required by FRS 3 but was rarely done in 1988 (when the forecast was disclosed). The remaining three notes deal with taxation, extraordinary items (permitted in 1988 prior to the introduction of FRS 3) and earnings per share.

As referred to earlier, Dixons’ (example 20) forecast was accompanied by a divisional analysis and by 11 notes (two of which were change in accounting policy notes). Other examples of forecasts that included notes are examples 16, 25, 66 and 72 (see full examples in O/S website address).

Disclosure of information privately

This section shows that forecast information is disclosed privately as well as publicly and that the use of forecasts for the purposes of rhetoric and argument occurs in fora other than in published profit forecasts.

It is easier to disclose information privately to a small number of large shareholders. Research has previously found a relationship between disclosure of forecasts and the presence of large block shareholders (Brennan, 1999). The following extracts provide evidence to support the proposition that information is disclosed privately. Coates Viyella (example 13) refers to information disclosed at a meeting with a member of the board.
The reference to pre-tax profits indicated by Tootal for the year ended 31st January, 1990 is derived from contemporaneous notes of a meeting with a member of the Board of Tootal in May, 1989.

ANI (example 3) states that a profit forecast was disclosed privately to it and to other major shareholders.

When we met Aurora in October 1988 to discuss an offer for your company we were given a profit forecast for 1988 and an asset revaluation estimate. This information was also given to Aurora’s other major shareholders, including Electra. Shortly thereafter, Electra sold to us its entire holding of 19.1 per cent. at the Offer price.

Plessey (example 51) refers to meetings with larger institutional shareholders.

Since our circular to shareholders was posted on 21 August, senior executives of Plessey have met with most of your Company’s larger institutional shareholders to reinforce the message that this bid should be rejected. You will appreciate that it has not been possible to make personal contract with all shareholders. Plessey does have a large number of private shareholders who collectively own a significant proportion of the Company. If you are a private shareholder, I would like to take this opportunity to emphasise how important your support has been and continues to be to the Company.

Beazer (example 7) had to disclose management forecasts and estimates, solely because this information had previously been disclosed to Hanson during private negotiations. This example illustrates the dangers of disclosing private information. As is brought out in interviews (Brennan, 1998), once information is disclosed to one party, it must subsequently be disclosed to other interested parties if they request it.

The estimates of Beazer’s future financial performance was not reported on by reporting accountants nor financial advisors to the bid. The absence of reports on the projections is not explained.

Beazer does not as a matter of course make public forecasts or projections as to future revenues or results of operations. However, during the course of negotiations, Beazer provided certain confidential information to representatives of Hanson. See “Certain Considerations – Background of the Offer”. Such information included the estimates by Beazer's management of Beazer's future financial performance that are set forth below (the "Beazer Information").

Forecast profits not reported on

Many takeover documents refer to future profitability which, without amounting to a formal profit forecast, intimates information concerning future results. Many companies provided dividend forecasts (which are generally not reported on by accountants) in place of formal profit forecasts – which could be construed as making a profit forecast ‘by the back door’. Only one company in the sample had its dividend forecast formally reported on.

Earlier in this chapter, attention was drawn to Beazer’s (example 7) estimates of future financial performance which were not reported on by reporting accountants/financial advisors.
Tootal (example 69) refers to expected improvement in profitability ‘over and above ... this year’s profit forecast’. This appears to be a forecast and yet has not been treated as such or reported on by accountants in the takeover document.

**Tootal’s action to improve profitability for the future**

In each of its core businesses, Tootal has a number of specific projects whose contribution to profitability is expected to improve next year by some £7.5 million. This is over and above any contribution from these projects to this year’s profit forecast and does not include the effects of a general improvement in trading conditions. As described on pages 6 and 7, the investments for these projects are either in place or at a sufficiently advanced stage of implementation to offer clear prospects of improved profitability in 1992/93.

A number of specific projects are being implemented in each of Tootal’s core businesses which are expected to improve profitability. Some of these projects will begin delivering benefits during the current year - a total of £2.5 million of trading profits is included in the forecast for this year. Whilst it is not possible at this stage to forecast profits for 1992/93, it is expected that the contribution to profitability from these projects will further improve by some £7.5 million in that year. In addition, other opportunities for improved profitability will arise from normal sales and marketing initiatives, minor investments and any increases in overall demand resulting from the expected upturn in the textile cycle.

The information for Telephone Rental’s (example 68) graph of annual rent receivable comes (according to the sources of information note) from the management accounts. Telephone Rentals disclosed a forecast for the year to 31/12/1988, but this forecast did not include forecast rent receivable. Thus, the graph includes data which has not been reported on by accountants.

The following graph demonstrates TR’s success in replacing its income from the declining market for internal telephone systems with income from the liberalised market for external systems.

9. **Sources of information**

The graphs and accompanying commentary on pages 5 and 8 of this document, and the chart and accompanying commentary on page 6 of this document and references to the turnover or trading profits in individual activities of subsidiaries of TR, are based on the following information derived from the management accounts of TR:

**Annual Rent Receivable - UK Telephones** (as at 30th September)

<table>
<thead>
<tr>
<th>Year</th>
<th>Internal Systems</th>
<th>External Systems</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>9,147</td>
<td>1,129</td>
</tr>
<tr>
<td>1985</td>
<td>7,449</td>
<td>3,385</td>
</tr>
<tr>
<td>1986</td>
<td>6,068</td>
<td>5,713</td>
</tr>
<tr>
<td>1987</td>
<td>4,790</td>
<td>8,221</td>
</tr>
<tr>
<td>1988</td>
<td>3,923</td>
<td>11,325</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(£000s)</td>
<td>(£000s)</td>
<td>(£000s)</td>
<td>(£000s)</td>
<td>(£000s)</td>
<td></td>
</tr>
<tr>
<td>Internal Systems</td>
<td>9,147</td>
<td>7,449</td>
<td>6,068</td>
<td>4,790</td>
<td>3,923</td>
</tr>
<tr>
<td>External Systems</td>
<td>1,129</td>
<td>3,385</td>
<td>5,713</td>
<td>8,221</td>
<td>11,325</td>
</tr>
<tr>
<td>Total</td>
<td>10,276</td>
<td>10,834</td>
<td>11,781</td>
<td>13,011</td>
<td>15,248</td>
</tr>
</tbody>
</table>
Saint-Gobain (example 60) also disclosed ‘management estimates’ which were not reported on.

Management estimates of the results of Quartz & Silice for 1987 show turnover of FF235.5 million (£23.5 million) and profit before tax of FF22.7 million (£2.3 million).

DRG (example 21) refers to estimates of expected profits over the next eight years. Although a certificate of valuation of the properties is provided, this does not seem appropriate where profits are being forecast.

Our programme of disposals is expected to generate profits, after costs and tax, AT TODAY’S PRICES, of about £90 million over the next 8 years (1990-1997) of which at least £50 million will be realised over the next 5 years (1990-1994).

Some companies included projections in the takeover documents which were specifically referred to as not being forecasts (and therefore were not reported on) – see the Beazer example (Example 7) earlier. The extract below from De La Rue’s (example 18) defence document illustrates the point, as does the Mecca Leisure example (example 48) reproduced in chapter 6.

For illustration only, the table below sets out the arithmetic effect on Norton Opax’s earnings of the implementation of the Norton Opax Final Offer for De La Rue. It is based on (i) the 1988 published audited consolidated accounts of Norton Opax as adjusted to eliminate the impact of the benefits of the pension holiday (in accordance with Statement of Standard Accounting Practice No. 24 in respect of accounting for pension contributions) and an exceptional item. The resultant profit before taxation has been increased from 1988 by 0, 15, 20 and 25 per cent. per annum respectively; and (ii) the Norton Opax estimate of De La Rue’s (post Crosfield) earnings, adjusted for assumed cost savings less acquisition interest (adjusted for projected disposals) for 1990, increased by 0, 15, 20 and 25 per cent. respectively for 1991 (see paragraph 6 of the Appendix).

THESE FIGURES ARE NOT TO BE TAKEN IN ANY WAY AS PROFIT FORECASTS

Although Ultramar (example 70) stresses that the ‘possible outcome’ is not a forecast, it is difficult to see the distinction between it and a forecast. However, these projections were reported on. Additional guidance on this issue is provided in the 1998 edition of the City Code (compared with the previous 1996 edition). Rule 28.6 (g) states that explicit and prominent disclaimers must be included where earnings enhancement and merger benefits statements are not intended to be profit forecasts.
Prospects for 1992 and measures to improve cash flow (extract)
The prospects for 1992 are encouraging. Although it is difficult to make a forecast in respect of a year which has yet to start, your Board wishes to provide shareholders with as much guidance as it reasonably can. We have therefore combined a forecast for our upstream businesses with a projection of what might be achieved by our downstream businesses as more normal business conditions return. This implies net profit after exceptional items and earnings per share for 1992 of £126 million and 34p, respectively. It must be stressed that this is not a forecast; it illustrates what is possible as more normal business conditions return.

The strength of Ultramar...(extract)
Adding this to the forecast post-tax operating profit for the upstream businesses, and after adjusting for group items, interest, minorities and exceptional items, as set out in Appendix III, implies net profit for the Group after exceptional items for 1992 of £126 million and earnings per share of 34p. This is not a forecast of what will happen in 1992 but an illustration of the possible outcome as more normal business conditions return.

Conclusions

The analysis of disclosures of financial items in profit forecasts illustrates the wide variety of current disclosure practices. US professional regulations, unlike those in the UK, specify minimum disclosure in forecasts. Similar provisions in the UK would result in greater consistency between companies in forecast items disclosed.

Discussion of changes in accounting policies provides evidence of strategic disclosures by management – in nearly all instances, the change in policy improved forecast results suggesting systematic upward adjustment of profits. Further evidence of strategic disclosures by managers is provided in respect of items ‘forecast’ but not treated as a forecast and therefore not reported on by reporting accountants and financial advisors to the company.
5. Assumptions underlying profit forecasts

In this chapter, examples of assumptions disclosed in profit forecasts are analysed. The Stock Exchange’s ‘Yellow Book’ (Chapter 12, paragraph 12.23) states that the principal assumptions on which the profit forecast is based must be included with the forecast. Assumptions must relate to matters outside the control of the directors, must be readily understandable by investors, must be specific about the particular aspect of the forecast referred to and about the related uncertainty, must relate only to material uncertainties and must not include the business estimates underlying the forecast.

Section K of the City Code on Takeovers and Mergers states that any document in which a forecast appears must reproduce the assumptions, including commercial assumptions, on which the forecast has been based.

Extracts from forecasts relating to assumptions disclosed are reproduced in this chapter. These extracts are shown more completely, with full details of sources, in the web site supporting this paper (O/S insert web address).

Assumptions tend to reduce the certainty of the forecast and a preference for no assumptions has been expressed by users of forecasts (Brennan, 1998).

Examples of assumptions disclosed

Most assumptions disclosed in forecasts follow a standard wording and deal with standard matters such as assumptions that there will be no change in accounting policies, no industrial disputes, no change in interest rates, no change in the basis/rates of taxation etc. However, there is evidence that management select some company-specific assumptions which appear amongst the standard assumptions. It is possible that such company-specific assumptions are selected to (i) allow for the best possible forecast and/or (ii) to provide subsequent excuses in the event the forecast is not achieved.

P. J. Carroll (example 11) disclosed seven assumptions. Five of these assumptions are fairly standard i.e. commonly found in forecasts. However, assumptions (b) and (c) appear to be company-specific. In the case of assumption (b) it is assumed that the severe mortality problem will revert to normal industry levels – yet limited justification to support such an assumption is provided. The amount forecast for the year is IR£9.1 million. If assumption (b) does not turn out to be valid, forecast profits will be reduced by IR£3.9 million at minimum – there may be further losses after the year being forecast. Thus, assumption (b) has a very material effect on the forecast – which only careful reading of the detailed notes to the forecast reveals. Such assumptions, specific to the business, need to be read carefully. Assumption (c) adds to concerns.
The principal assumptions upon which the forecasts have been based are as follows:

(a) For the period from 1st September, 1990 to 31st March, 1991 the revenue from and gross margin on tobacco sales will be approximately the same as those experienced in the period from 1st September, 1989 to 31st March, 1990.

(b) The recent severe mortality problem, which is so far affecting only the 1990 crop of salmon smolts will revert to normal industry levels by mid-November, 1990. Should the mortality problem continue at the present level beyond that time, without compensating remedial action being effective, the loss of IR£0.6 million for the Aquaculture Division for the year ending 31st March, 1991 included in the forecast would increase at the rate of approximately IR£0.9 million per month up to a maximum of IR£3.9 million in the event of a total loss of the 1990 crop of salmon smolts; any such further losses would qualify for taxation relief at a rate of approximately 10 per cent.

(c) Other salmon stocks will not be materially affected by mortalities or abnormal weather conditions.

(d) Trading arrangements with principal suppliers, agents and customers will remain uninterrupted and no major supplier, agent or customer will fail to meet its commitments.

(e) Operations will not be materially affected by industrial disputes or breakdowns within the Carrolls Group or its major suppliers, agents or customers or by litigation or changes in legislation.

(f) There will be no material change in the bases and rates of excise duties and other taxation, or in economic conditions, interest rates or exchange rates.

(g) The executive management of Carrolls, its policies and operational activities will remain unaltered prior to the publication of the audited accounts for the year ending 31st March, 1991.

The assumption disclosed by Highland Participants (example 34) concerning shiprepair, shipbuilding and oil bunkering is very detailed and very company-specific. The wording used (There is no assurance, therefore, that the assumed levels will be achieved) creates considerable uncertainty about the forecast. Neither the Listing Rules nor the City Code require the assumptions disclosed to be reasonable, nor are reporting accountants responsible for the assumptions – they only have to state whether the calculations are consistent with the assumptions disclosed. It seems to be a weakness in the regulations that assumptions can be made where there is no assurance that they can be achieved.

Shiprepair, shipbuilding and oil bunkering are volatile businesses. The nature of these businesses requires the Directors to estimate the likely levels of labour utilisation and man-hour rates in shiprepair and shipbuilding, and trading volumes in oil bunkering. Variations in the level of these assumed factors will affect the income receive by the Group. There is no assurance, therefore, that the assumed levels will be achieved. In addition, the Group’s operations are becoming more concentrated in the property market. Therefore, the Group’s profit is increasingly sensitive to fluctuations in this market. The forecast includes a profit of £1 million on a property disposal which is anticipated to be completed before the year end.

The forecast for the three months ending 31 December 1989 assumes the following levels of activity for the shiprepair, shipbuilding and oil bunkering businesses of Highland: average labour utilisation levels and man-hour rates in shiprepair and shipbuilding activities are similar to those achieved in the last quarter of 1988 and oil bunkering volumes increase at a rate similar to the rate of growth experienced in the first nine months of 1989. The Directors believe that the estimates for these variables upon which their forecast is based will be achieved.

This forecast assumes that there will be no strikes, disasters, natural or otherwise, or changes in current legislation.
Sketchley (example 63) disclosed a forecast in defending a bid from Godfrey Davis. The forecast was repeated (example 64) in defending a subsequent bid from Compass Group. Comparing the forecasts shows that the assumptions changed substantially between the two. Given that there was less than a month between the two forecasts, it is hard to believe that much had changed to account for the changes in assumptions.

The first forecast disclosed nine assumptions (marked in the example below) compared with two in the repeat forecast. The rather standard assumptions (assumptions 2 to 9) of the first forecast (example 63) were not repeated. The changes in assumptions (especially considering that the forecast itself was not changed) suggests some strategic choice of assumptions by management - possibly to provide them with greater protection if the forecasts were not achieved. In particular, the reference to compensation payable to the chairman did not appear in the first forecast. Alternatively, management may have been responding to criticisms of the assumptions in the first forecast.

The first forecast stated that the costs of the defence were not taken into account in the forecast. The second forecast quantified the defence costs at £1.2 million and, in addition, stated that the compensation payable to a former chairman was also not taken into account in the forecast. One needs to be wary of costs excluded from a forecast.

First forecast (made on 1 March 1990)

No account has been taken of the costs of the defence of the Offer.

The principal assumptions underlying the forecasts are as follows:
(a) The seasonal pattern of sales in previous years will be repeated and will not be distorted by prolonged weather conditions;
(b) There will be no widespread industrial disputes or abnormal operating problems at the works of Sketchley’s suppliers or customers;
(c) There will be no adverse effects from changes in taxation or other legislation; and
(d) There will be no significant changes in interest rates.

Second ‘repeat’ forecast (made on 31 March 1990)

The costs of the defence of the offer for Sketchley by Godfrey Davis (Holdings) Plc are estimated to be £1.2 million and this is not reflected in the above profit estimates.

No account has been taken of any compensation payable to Mr M Glenn, the former Chairman of Sketchley, the amount of which has not yet been determined.

Steetley’s forecast (example 65) also does not take account of the costs of the defence of the offer. The disclosures illustrate how high defence costs can be ‘...approximately £8.0 million in respect of defence costs associated with the Redland bid’.

Conclusions

The analysis of disclosures of assumptions in profit forecasts in this chapter illustrates the wide variety in current disclosure practice.
Careful reading of the assumptions in forecasts is essential. Some (especially company-specific assumptions) create considerable uncertainty as to the reliability of the forecast. In some cases, the assumptions seem to be used by management to provide protection if the forecast is not subsequently achieved. These assumptions seem to serve management’s own self-interest, possibly at the expense of shareholders.
6. Rhetoric and argument in forecasts and takeover documents

Chapters four and five have examined items and assumptions disclosed in forecasts and have discussed their role in communicating messages to shareholders and their effectiveness in persuading shareholders of those messages. This chapter focuses on the verbal jousting in takeover documents and examines forecast-related disclosures in the context of their use for the purpose of rhetoric and argument during takeover bids. Many of the examples in this chapter are not directly from forecasts themselves but appear in takeover documents and refer to forecasts.

There are two parts to the chapter. First, material used by management for the purpose of persuading shareholders to management’s point of view is discussed. These persuasive disclosures are considered under four headings: (i) explanations for absence of forecasts; (ii) explanation concerning current trading and prospects; (iii) use of third party and other forecasts; and (iv) use of dividend forecasts. In many cases, the discussion of these disclosures points to weaknesses in the persuasive material used.

The second part of the chapter examines attacks by the other side to the bid on (i) the absence of a forecast; (ii) the content of forecasts disclosed; (iii) accounting policies; (iv) assumptions; (v) dividend forecasts and (vi) business and company performance. Contested takeover bids provide a unique setting in which to examine the verbal jousting in respect of accounting disclosures because of the existence of two (or more) parties to the bid. Thus, all the examples illustrating attacks on the other side relate to contested bids and appear either in offer documents or defence documents depending on whether the attack is by a bidder or a target.

**Persuasion - Absence of forecasts**

Disclosures in takeover documents are nominally directed shareholders. However, in the context of takeover bids there is an additional audience to be considered - the other party to the bid (i.e. the bidder or target company). Disclosures are often made with the other party to the bid rather than the shareholder in mind. For example, a small number of companies referred to the absence of a forecast – possibly in anticipation of criticism of non-disclosure.

The main reasons given for not disclosing a forecast were uncertainty due to volatile market conditions (A. Goldberg & Sons (example 31)), it being too early in the financial year (Mecca Leisure (example 46)) and other uncertainties (Amshold, example 2).
Given that future results will be highly sensitive to changes in sales volume and margins, the Board has been advised by its financial advisers and auditors that it would not be practicable to provide a forecast of likely outcome for the financial year to March 1990.

Whilst it is too early to forecast the results for the current financial year, operating profits are broadly in line with your Board’s expectations.

(e) Forecasting
The Directors have discussed their internal budgets, projections and estimates for the period to 31 December 1993 with Kleinwort Benson and Touche Ross & Co. As a result of the uncertainty inherent in the projections, and the level of contingencies which would have to be included, the Directors are unable to present a meaningful forecast of profit or loss in the context of the Proposal.

Target company Bejam did not make a forecast. However, the bidder, Iceland Frozen Foods (example 36), made its own forecast of Bejam’s results. Thus, in the verbal jousting between bidders and targets, disclosure (or in this case non-disclosure) of information can influence the other side’s disclosure behaviour. The absence of a forecast by Bejam presented Iceland Foods with an opportunity to make its own (presumably low estimate) of the target’s profits. It is likely that Bejam did not anticipate this reaction when it choose not to make a forecast.

We have already highlighted Bejam’s poor trading performance, with Bejam’s Chairman stating only last month that the disappointing 1988 results had continued into the current year. We therefore do not believe that your Board can forecast current year pre-tax profits of more than £27.1 million, a small increase on last year’s disappointing results.

Persuasion - Current trading and prospects

Most companies include a paragraph in the takeover document on current trading and prospects. Without making a formal forecast, boards can give shareholders an indication of companies’ performance. Penny & Giles’ (example 49) chairman did not give shareholders reason to be optimistic. While indicating lower profitability (difficult markets, pressure on margins) he suggests at the same time that management has been doing a good job (sales have held up well, market shares…maintained, introduction of…new products). This was a recommended offer and the chairman appears to be trying to persuade shareholders to accept the terms of the bid - that the offer price was fair and did not undervalue the company.

In the interim announcement released in November 1991, I stated that we had revised our plans for growth due to difficult market conditions. Since then there has been no improvement in the principal markets in which Penny & Giles operates.

Despite this difficult trading environment, sales have held up well and market shares have been maintained. This has been achieved through the introduction of a number of new products and concentrated marketing effort, but at the expense of some further pressure on margins, despite actions taken earlier in the year to reduce costs.

Lloyds Chemists (example 44) were much more upbeat. As bidder, Lloyds Chemists was clearly trying to persuade target company shareholders that it is a successful, well-managed company. However, the phrases used (…commercial and financial strengths, future growth, significant force)
appear vague. The lack of detail to back up these statements takes away from their persuasiveness.

We believe that the prospects of the enlarged Lloyds group are excellent. Both Macarthy as well as existing Lloyds shareholders can expect to benefit from the commercial and financial strengths and future growth of the enlarged group. The enlarged group will be a significant force in the health care industry, being the second largest chain of chemist stores, the second largest chain of drugstores and the largest specialist health food retailer, as well as having interests in pharmaceutical and veterinary products, and the wholesaling of toiletries. Lloyds’ results for the current financial year will reflect our strong trading, and will also include benefits from the businesses which we acquired in 1991, including Kingswood-GK and Holland & Barrett.

Persuasion – warranty

The behaviour of owner shareholders can act as a signal in influencing other shareholders. Argyle Trust (example 4) made a forecast for 1988 of £1.4 million. In addition, the chairman (holding 16.9 per cent equity) on a personal basis warranted to the bidder that profits for the following year 1989 would not be less than £3 million. This forecast (which is what the profit warranty amounts to) was not reported on by reporting accountants and financial advisors. The value of this personal warranty is somewhat reduced by its restriction to £500,000. Legally, the value to shareholders of this warranty is questionable.

You will, however, note that Mr. Oppenheim has (subject to certain conditions) given an irrevocable undertaking to accept the Offer in respect of the 3,610,000 Argyle Shares owned or controlled by him (representing approximately 16.9 per cent. of the present issued share capital) and has personally warranted (subject to a maximum liability on him of £500,000) that the pre-tax profits of Argyle for the year ending 31st December, 1989 will be not less than £3,000,000. Further details of the profit warranty are set out in Part 8 of the Particulars Card.

Persuasion - Use of third party and other types of forecasts

Future orientated information, not in the nature of a formal forecast (and therefore not requiring to be reported on by reporting accountants/merchant bankers), was included in offer documents in some cases. In most cases, this information was used to persuade shareholders to support management’s position.

Estimates of oil and gas reserves, estimates of net asset values, estimates of copyright valuation, estimates of patent valuation and estimates of embedded values were found which were reported on by independent experts such as accountants, engineers, mining consultants, chartered surveyors, merchant bankers and actuaries.

Takeover documents frequently include forecasts of non-financial items. Many of these items were not independently reported on by accountants and financial advisors to the bid.

Without making a profit forecast, Freemans (example 28) creates the impression of improving results by forecasting an increase in ‘active agents’. Management are attempting to create the impression of improved performance and results. In practice,
it does not follow that increase in agents will increase profits. Putting the phrase **absolutely sound base** in bold begs the question.

We start 1988 from an **absolutely sound base**. We expect to have 730,000 active agents at the start of the new financial year - an increase of almost 6 per cent over the past 12 months.

It is not uncommon to see takeover documents include reference to the size of companies’ order books to give the impression of improving profitability without disclosing a formal forecast. Aurora (example 5) used such a tactic.

The Group’s order book has increased by more than 70 per cent. since the beginning of the year and now stands at £42 million.

Aurora has excellent future prospects, as demonstrated by its order book which now stands at £42 million, an increase of more than 70 per cent. since the beginning of the year.

Ricardo (example 57) also included information on the value of its order book to suggest good results and prospects without making a formal profit forecast.

**The offer is wholly inadequate (extract)**

It does not reflect the value of Ricardo’s order book of over £21 million and its excellent prospects.

Consolidated Gold Fields (example 15) projects increased interest (not defined) in gold production to suggest improving results. Some detail is provided on the basis for this information and on how these projections are arrived at – but, as will be seen in the next example, the basis for the calculation was changed soon after – possibly in response to criticism of the original forecast.

Gold Fields interest in gold production has increased by 21 per cent. over the past three years to 1.4 million ounces. By 1991 it is projected to rise by a further 44 per cent. to over 2 million ounces. This growth is the direct result of successful exploration.

**Bases and sources of financial information (extract)**

(f) The projections of Gold Fields interest in gold production contained on pages 2 and 3 are derived from internal estimates prepared by the relevant members of the Gold Fields Group and are based on operating plans which assume gold prices in 1991 of US$431 per ounce, A$599 per ounce and R48,400/kg respectively for US, Australian and South African operations.

Consolidated Gold Fields (example 16) repeated its forecast of gold production in a subsequent bid from Minorco. The forecast did not change but the explanation of its calculation did. Most notable is the change in the price of gold used, which dropped from US$431 to US$400 per ounce. This drop in price did not, however, change the projections. No explanation is provided for the change in gold price used. Management presumably did not expect shareholders to read the material carefully enough to be concerned about the change.
Gold Fields total beneficial gold production has risen 21 per cent. over the last three years to 1.4 million ounces per annum. Over the next three years, it is planned to rise a further 44 per cent. to over 2 million ounces.

Notes:
(r) The projections of Gold Fields total beneficial gold production on page 7 are to its proportionate interest in the production of its subsidiaries and associates. The projection on page 3 of Newmont Gold’s gold production in 1989 and the projections of Gold Fields total beneficial gold production for 1991 have been derived from internal estimates prepared by the relevant members of the Gold Fields Group and are based on operating plans which assume gold prices in 1991 which reflect the operation on a 1989 gold price of US$400 of internal assumptions as to local inflation and exchange rates for the period 1989 to 1991.

Takeover documents frequently include forecast information of third parties such as brokers’ forecasts. Coalite (example 12) clearly did not want to make its own forecast and at the same time wanted to communicate good performance to shareholders. Instead it used brokers’ forecasts in lieu of making its own forecast to persuade shareholders of the value of the offer.

Coalite is expected to announce earnings per share of 32.9p for the year ended 31st March, 1989 (consensus of brokers’ forecasts May, 1989 Earnings Guide). This represents a compound increase in earnings of only 2 per cent. per year over the last three financial years (after making an adjustment for inflation).

The Offer represents a price earnings multiple of approximately 13.6 times (based on pre-tax profits of £45.5 million of Coalite) for the period ended 31st March, 1988 and approximately 12.9 times (based on the above brokers’ forecasts of pre-tax profits of £48.1 million) for the period ended 31st March, 1989.

Forecast information of third parties may be used to estimate profits of the other party to the bid. In a contested bid, Mecca Leisure (example 48) – the bidder, used brokers’ forecasts to make its own projections of the target company Pleasurama’s profitability - conditional on the takeover going ahead – which implies to target company shareholders that new (bidder) management would have a beneficial effect on the target’s performance.

For illustration only, the table below sets out the arithmetic effect on Mecca’s earnings of the implementation of the Final Offers. It is based on the consensus profit projection for 1989 for Pleasurama, including Hard Rock, shown in the Earnings Guide for September, 1988; Mecca’s forecast earnings per share (excluding property profits) for 1988 increased by 0, 10 and 20 per cent. Respectively; and, incorporating illustrative levels for synergy benefits of 8, 9 and 10 per cent. of the combined group’s profits before tax.

<table>
<thead>
<tr>
<th>Illustrative growth in Mecca’s 1989 earnings per share compared with 1988 forecast of 14.4p</th>
<th>0%</th>
<th>10%</th>
<th>20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings per share</td>
<td>14.4p</td>
<td>15.8p</td>
<td>17.3p</td>
</tr>
<tr>
<td>Earnings enhancement or dilution in enlarged Group with synergy benefits before tax of: 8%</td>
<td>+6%</td>
<td>-1%</td>
<td>-7%</td>
</tr>
<tr>
<td></td>
<td>+7%</td>
<td>0%</td>
<td>-6%</td>
</tr>
<tr>
<td></td>
<td>+8%</td>
<td>+1%</td>
<td>-5%</td>
</tr>
</tbody>
</table>

The use of brokers’ forecasts can be very selective – presumably to present the best possible picture. Some firms use consensus forecasts from, say, The Earnings Guide.
Other companies use fewer (as low as one) brokers’ forecasts. Wassall (example 73) explained why it used only one brokers’ forecast.

James Capel’s estimate of Metal Closures’ pre-tax profits for the year to 31 December, 1989 is £5.7 million. If this proves accurate, these profits will be nearly 25 per cent. below the 1988 level and actually lower than those achieved in 1978, 1979, 1981, 1983, 1984 and 1987.

**Profits are erratic and show no growth.**

![Graph of Metal Closures pre-tax profit](image)

6. **Sources and bases for calculations (extract)**

7. Forecast pre-tax profits of Metal Closures

James Capel, Morning Meeting, 6 September, 1989. (James Capel are the only broker named in The Earnings Guide, November, 1989 edition in respect of Metal Closures.)

Coates Viyella (example 14) made very full disclosure of how it calculated its consensus brokers’ forecast. However, one might question why the company did not use a published consensus forecast rather than calculating one itself. Coates Viyella’s consensus brokers’ forecast is based on the individual forecast of six brokers. The note, however, does not say why those particular brokers’ estimates were chosen. However, there is good explanation of why one broker’s estimate was excluded from the calculation. It enhances the disclosure that exclusion of the one estimate has an adverse effect on the consensus forecast. This adds credibility to the disclosure.

<table>
<thead>
<tr>
<th>Date</th>
<th>Name</th>
<th>Earnings per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>27th February, 1991</td>
<td>James Capel &amp; Co. Limited</td>
<td>4.0p</td>
</tr>
<tr>
<td>8th February, 1991</td>
<td>Hoare Govett Investment Research Limited</td>
<td>4.4p</td>
</tr>
<tr>
<td>21st February, 1991</td>
<td>Barclays de Zoete &amp; Bevan Research Limited</td>
<td>3.9p</td>
</tr>
<tr>
<td>February, 1991</td>
<td>UBS Phillips &amp; Drew</td>
<td>4.2p</td>
</tr>
<tr>
<td>11th February, 1991</td>
<td>Carr Kitcat &amp; Aitken Limited</td>
<td>4.2p</td>
</tr>
<tr>
<td></td>
<td>Average</td>
<td>4.1p</td>
</tr>
</tbody>
</table>

In addition, in February 1991, Henry Cooke, Lumsden plc published an estimate of 6.3p for Tootal’s earnings per share for the year ended 31st January, 1991, but stated that its revised estimate assumes no change in accounting practices following the management changes. As the estimate has been compiled on a basis which Coates Viyella believes to be inconsistent with the estimates which comprise the consensus estimate, it has not been included. If its estimate were included, the consensus estimate would be 4.4p.
The range and choice of forecast information from other sources used in takeover documents is extensive. Telephone Rentals (example 67) based its estimate of Mercury’s business customers on a newspaper report. The reliability of this information must be questioned – it is possible that the information was leaked to the Daily Telegraph by the management of Telephone Rentals.

<table>
<thead>
<tr>
<th>The Claims</th>
<th>The Facts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cable and Wireless claims that TR would benefit from Mercury’s customer base.</td>
<td>With 50,000 UK installations, TR has a substantially larger business customer base than that represented by Mercury’s reported 9,000 business customers.</td>
</tr>
</tbody>
</table>

3. Sources of information (extract)
(a) The estimate of business customers of Mercury used on page 5 is derived from a report in the Daily Telegraph of 1st September 1988 relating to the launch of Mercury’s customer compensation scheme.

Ruberoid (example 59) used a forecast by the Building Materials Producers Association to imply an increase in its own business in the future. No justification is provided for this implication.

Ruberoid derives substantial business from commercial and industrial building which are forecast by the Building Material Producers Association, to enjoy increases in 1989.

Bases for information (extract)
(7) The reference on pages 6 and 8 to the forecasts by the Building Material Producers Association is taken from the 1988 report by the National Council of Building Material Producers.

Persuasion - Dividend forecasts (easy alternatives to profit forecasts?)

In lieu of a profit forecast, many companies disclose dividend forecasts which do not have to be reported on by the accountants or financial advisors to the bid. A forecast of dividends is not normally considered to be a profit forecast, but it will be where it is accompanied by an estimate of dividend cover (City Code, Rule 28.6 (f)).

HSBC (example 35) made such a dividend forecast. The 8.1 per cent. increase forecast is suggestive of a similar increase in profits.

On 10 March 1992, the Board of HSBC Holdings stated that, in the absence of unforeseen circumstances, the Directors expect to recommend dividends for 1992 of not less than HK$2.00 per share (equivalent to 14.5p at the current exchange rate), an 8.1 per cent. increase over the dividends for 1991. The Board of HSBC Holdings reaffirms this forecast which applies both to the new HSBC Holdings shares and to the existing HSBC Holdings shares.

Plessey (example 52) confessed to being unable to make a formal profit forecast but nonetheless was able to make a dividend forecast. The borderline between making and not making a profit forecast can be narrow. In addition, Plessey implies increased dividend payout to shareholders in the phrase This dividend forecast signifies the determination of your Board that the benefits of the Company’s strategy should flow through to shareholders.
Dividend Forecast

At this early stage in Plessey’s financial year and given the complications of the GPT structure, your Board feels it would not be appropriate to make a formal forecast of Plessey’s profit for the year to 31 March 1990. At the same time, your Board is fully confident regarding the Company’s prospects and firmly believes the future strategy for the Company, already explained to you, should produce significant benefits for shareholders.

As a measure of this confidence your Board has decided that, in the absence of unforeseen circumstances, it intends to recommend a total net dividend for the current year of 9.19p, representing an increase of 20% over last year. Since 1985 increases at the rate of 15% per annum have been achieved and taking account of the forecast dividend the income on your shares will have more than doubled over this period. This dividend forecast signifies the determination of your Board that the benefits of the Company’s strategy should flow through to shareholders and its belief in the future quality of the Company’s performance.

The dividend forecast is almost invariably accompanied by the wording ‘in the absence of unforeseen circumstances’. Dewey Warren (example 19), however, did not use this phrase when it made its dividend forecast.

Dividends

The Board intends, shortly after completion of the Acquisition, to declare a special interim dividend on the ordinary share capital of the Company calculated by reference to anticipated earnings in the period prior to completion of the Acquisition. The Board anticipates that this special dividend will be 6.5p net per Ordinary Share. No interest will be payable on the New Stock by reference to that special dividend. In addition, your directors currently intend to recommend a final dividend of not less than 5p net per Ordinary Share for the period ending on 30th June, 1990. These proposed dividends represent a gross annualised yield of not less than 8.8 per cent (see paragraph 15 of Part 10).

Thereafter, it is the present intention of the Board of Dewey Warren to adopt a policy of distributing by way of dividend the majority of its profits available for distribution to shareholders.

However, when the bid did not proceed, Dewey Warren (example 19) reversed its dividend intentions. Not only was the final dividend cancelled but the undertaking to adopt a policy of distributing by way of dividend the majority of its profits was also abandoned.

In view of the termination of the proposed Acquisition, the Company’s accounting reference date will remain 31st December, and your Board no longer intends to recommend a final dividend for the period ending on 30th June, 1990, as had been indicated in the circular dated 20th September, 1989. The Company’s future dividend policy is being reviewed by your Board.

Camford Properties (example 10) devoted an entire page in its defence document to the forecast dividend. It is difficult not to think of this as being in substance a profit forecast. To enhance the undertakings given, details of dates of the first and second payments are given.

Forecast New Property Dividends

As funds are released from our property resources, Camford will invest the proceeds initially in the money markets and then in our growing engineering businesses. Additionally your Directors intend in future to distribute to shareholders a proportion of our property gains and the income generated therefrom. Your Board forecasts that Camford will, in the absence of unforeseen circumstances, pay annual property dividends amounting to
15 pence net per Camford share

for at least the next three financial years. The new property dividends will be in addition to the normal dividends to be paid out of earnings from Camford’s engineering businesses.

It is intended that these property dividends will be paid in two equal instalments of 7½ pence net each, usually coinciding with our normal dividend payments. The first payment, an interim in respect of the year ending 30th September, 1991, will be made in December 1990. The second payment, a further interim for that year, will be made in July 1991.

After three years, we shall review our property dividend payments in the light of our progress in realising Camford’s surplus property assets and of the returns obtained from reinvesting the realised proceeds in our engineering businesses. It would be the longer term aim of your Board that our aggregate dividends would be at least maintained thereafter.

Attacks for absence of forecasts

The use of accounting information in a positive way to persuade shareholders to support management has been illustrated in the previous sections. Persuasion of shareholders to support management may be done negatively by attacking the other party to the bid.

There can be considerable pressure on companies to disclose a forecast, particularly when the bid is contested. If a company does not disclose a forecast there is a likelihood that the other party will criticise this non-disclosure. This is especially so if the company has referred to future prospects without making a formal forecast or is near its year end. Such was the case with Thompson, as the bidder, Ladbroke Group (example 42), pointed out:

Again, with some eight and a half months’ trading results available to them, there can be no excuse for the board of any well managed company failing in the circumstances to inform shareholders as to its current trading performance; the Thompson board, however, has failed to give you this information.

In its response to the Ladbroke Offers, the Thompson board resorted to providing so-called proforma annualised operating profits, prepared on differing bases. These are totally confusing and misleading as a representation of the actual results for the year to 30th April 1988 and are no substitute for a 1989 profit forecast.

Your board must provide you with a profit forecast for the year to 30th April 1989 by division so that you are able to make an informed judgement of the merits of the Ladbroke bid.

IMI (example 38) used the absence of a forecast to attack Birmingham Mint’s dividend forecast. Strong, forthright language is used in this (and the previous) example.

- Despite claims of “excellent prospects for the 1990s” your board has failed to publish a profit forecast to justify this claim.
- The forecast full year dividend of 6.5p is irresponsible. It will not be adequately covered by earnings and will further weaken the cash position.

There is no evidence to suggest that future dividends can be sustained at this level.

Grampian (example 32) attacked Macarthy for not providing a forecast. Shareholders in Macarthy were not convinced by this attack as Grampian’s bid was not successful.
Macarthy has not given any clear information on its current trading and still has not published the interim results for the six months ended 31st March 1991. As shareholders, you must be wondering why your Board is unable or unwilling to provide any indication of the results for the current financial year and whether Macarthy’s earnings per share in 1991 will reach even last year’s level.

**Attacks on forecasts**

Profit forecasts are frequently attacked in contested bids. This, to some extent, affects forecast content as the forecaster must consider the other party’s reaction to the forecast. Earlier in this chapter some doubt was cast on whether shareholders read the detailed notes to forecasts. In a contested bid, the forecaster can be certain that the other party to the bid will examine the detail carefully, and will highlight any weaknesses or inconsistencies therein.

Pleasurama (example 50) attacked Mecca’s forecast because it excluded losses of a subsidiary.

**MECCA’S GROWTH: 24 OR 10 PER CENT?**

Mecca forecasts growth in earnings per share of not less than 24 per cent. (before exceptional property profits). This forecast includes the one-off benefit from the timing of the acquisition of Ladbroke Holidays. The exclusion of 3 of Ladbroke Holidays’ loss making winter months is estimated to have saved £1.5 million and next year’s results will bear the full impact of these losses. Pleasurama estimates that if this benefit had not been available and financing for the acquisition had been in place for the full year, the pro forma growth in earnings per share (before exceptional property profits) would have been less than 10 per cent. (assuming that Mecca’s profit forecast for the year ended 30th September 1988 is exactly achieved).

Epicure (example 23) attacked Habit Precision for its choice of interest rate in forecasting its profits.

The profit forecast assumes no increase in interest rates. Base rate has subsequently risen by one per cent. to add to the interest costs of £650,000 on an unacceptably high level of borrowings and gearing.

Epicure (example 24) also attacked Habit Precision for forecasting operating profit, ‘a meaningless figure for shareholders’.

Most unusually, your board has chosen to highlight operating profit in its forecast - a meaningless figure for shareholders. The relevant figures for shareholders are the forecast pre-tax profit of £1.25 million, which will be even less than the pre-tax profit of £1.5 million earned two years previously, and the forecast earnings per share of 5.9p which will be nearly 22 per cent. lower than two years previously. Forecast earnings per share could be even lower if Doric is not sold by 30th September, 1989.

Accounting methods may also be attacked. Embedded value accounting, treatment of costs as extraordinary, below the line, items rather than exceptional items (and vice versa in the case of revenues), capitalisation of costs, release of unused provisions to forecast profits, accounting for subsidiaries acquired and disposed of, and treatment of pension costs are all accounting methods that were attacked.
American Brands (example 1) attacked Invergordon Distillers for the sudden increase in forecast profits compared with brokers’ forecasts. The forecast was attacked for manipulation of stock levels, production levels and marketing spend to the benefit of the forecast. The possible once-off release of provisions was also highlighted.

**1991 profit forecast**

- The Board of Invergordon has failed to explain to shareholders why its 1991 profit forecast is suddenly so much higher than its own broker and other analysts were recently forecasting, particularly when first half turnover was significantly below brokers’ forecasts.

- Shareholders need answers to the following questions
  - **Stock**
    How much of the forecast profit increase is the result of accelerating the sale of stocks of maturing whisky or switching from bought-in stock to cheaper company-produced stock - resulting in an unsustainable rate of profit growth?
  
  - **Production levels**
    Is your Board boosting profits by not adhering to its previously stated policy that it would cut production substantially this year? If so, more severe production cuts are likely in 1992.

  - **Marketing expenditure**
    How much of the forecast profit increase is the result of a reduction in much needed brand development and advertising expenditure thereby increasing Invergordon’s vulnerability by allowing its small branded market share to continue to stagnate?

  - **One-off release of provisions**
    How much of the forecast profit increase is the result of the one-off release of balance sheet provisions?

**1992 profits**

- Invergordon boasts that its forecast profit is a year ahead of expectations but says absolutely nothing about prospects for 1992. In the light of 1991 forecast profits possibly boosted by one-off items and with challenging market conditions ahead, will Invergordon achieve any real growth in its operating profit in 1992 and beyond?

As shown in chapter 3, forecasts can be point, range or non-quantified. Various wordings are used for range forecasts. Sears (example 61) attacks Freemans for its choice of wording.

**FREEMANS DISMAL PROFIT FORECAST...**

1987/88 has been a year of real decline for Freemans (extract)  
With only three weeks of the financial year to run, we expected to see a firm forecast with a minimum profit figure (e.g. “not less than...”). Even at this late stage your Board has been able to do no more than forecast that pre-tax profits will be “of the order of £33.2 million” - i.e. **profits could be even lower.**

A figure of £33.2 million is the absolute minimum required to avoid a fall in earnings per share. If the out-turn were lower, **you would face a fall in earnings per share this year.**

Some companies were attacked for using misleading information in their forecast. General Motors (example 30) made such an attack on SD-Scicon. No explanation was provided however to explain why the use of software company prices is misleading or to suggest an alternative approach to the calculation.

SD-Scicon multiplies its forecast profits by other software company price earnings multiples. This is misleading.
Iceland Frozen Foods (example 37) attacked Bejam for presenting misleading comparative figures.

The statistics quoted by your board on Bejam’s profits disguise the all important difference in the underlying trends of our respective companies - which show Iceland is growing rapidly and Bejam is static or declining - this results from Bejam’s highly selective choice of presenting only a one year comparison.

Attacks on accounting policies

In contested bids, companies changing accounting policies for the purpose of a forecast run the risk of being attacked by the other side. Such was the case for Irish Distillers which was attacked by the bidder GC&C Brands (example 29) for changing its accounting policy (see example 41 in chapter 4).

The Board’s latest profit forecast (the second in six weeks) is helped by a timely change in accounting policy and once-off rationalisation benefits. These cannot disguise the continuing poor trading performance.

Shareholders should note that more than 75 per cent. of the forecast increase in pre-tax profits is due to the reduction in costs following last year’s redundancy and rationalisation programme and to a material change in accounting policy.

Attacks on assumptions

Sears (example 62) attacks Freemans for its choice of assumptions and raises questions on the uncertainty in the forecast. Chapter five points to the importance of company-specific assumptions compared with the standard wording of many assumptions. Sears expresses concerns about one such company-specific unusual assumption.

FREEMANS DISMAL PROFIT FORECAST...
1987/88 has been a year of real decline for Freemans (extract)
The forecast is based on the assumptions that there will be no bad weather or disruption of distribution (problems which have already occurred earlier this year) and relies on an unusual assumption - that stocks which Freemans holds for Spring/Summer 1988 prove to be “in accordance with the levels in previous years”. Given the errors made by your Board in the current year - too much stock in June, too little stock in October - this injects further uncertainty into the forecast.

Earlier in this chapter Ricardo’s forecast of its order book was discussed. This estimate of its order book was attacked by the bidder, First Technology (example 26) on the basis of the unreliability of the estimate as two different amounts were forecast. This attack is a little unfair as it implies that both amounts were forecast by the target where, in fact, one was a broker’s forecast. An additional criticism (derived from information in a newspaper article) is thrown in at the end of the excessive dependence on Russia.
**Ricardo order book**

Considerable play was made by Ricardo in their defence document of their record order book. They said:

“Our order book, including the substantial Russian contracts, now stands at over £20 million, the highest that we have ever had.”

It is interesting to recall that Ricardo’s broker in a note dated 8th September, 1988 stated:

“The order book is very full at present and totals over £30 million”.

There seems to be some question of just what constitutes a record order book. Furthermore, an article in Investors Chronicle, dated 18th February 1988, spoke of Russian contracts totalling £14 million. This underlines a very heavy dependence on the Eastern block.

**Attacks on dividend forecasts**

Dividend forecasts are rarely attacked. An exception is the attack by Industrivarden (example 39) on Redfearn’s dividend. The attack is based on the size of the forecast increase, the absence of increase in the interim dividend and lowering of the dividend cover.

**A defensive dividend increase**

Shareholders could be forgiven for being sceptical about the size of the increase in the final dividend proposed by the Redfearn Board. At the half year, in the light of the disappointing results, the Board did not see fit to recommend any increase in dividend. However, despite the fall in earnings per share, it has now proposed an increase in the dividend for the year as a whole of nearly one half. This results in a much lower level of dividend cover than the Board has, in recent years, considered appropriate. Moreover, the dividend cover figure published in the Redfearn defence document benefits substantially from the particularly low tax charge in the financial year just ended.

Would this dividend have been declared in the absence of our offer? Can this be described as prudent?

**Attacks on the business and on company performance**

In contested takeover bids, target and bidding company managements are competing for the right to run the target company business. Each tries to persuade shareholders of their own competence and, at the same time, of the incompetence of the management of the other side.

BTR (example 8) uses analysts’ forecasts to attack the other side’s profitability and to cast doubt on the competence of Hawker Siddeley’s management.

Nothing in these results suggests that Hawker Siddeley's present senior management team will prove any more successful than its predecessors. An average of financial analysts’ recent forecasts predicts that Hawker Siddeley's pre-tax profits will fall to £119.9 million in 1991.

Pleasurama’s forecasting ability was attacked by Mecca Leisure (example 47) for failing to meet its own broker’s forecast.

Pleasurama’s results for each of the last two years have fallen significantly below market expectations, and failed to meet forecasts made by its own broker less than six weeks before the end of each trading year.
How reliable, therefore, are forecasts or predictions relating to the future performance of Pleasurama?

First Technology (example 27) used brokers’ forecasts to attack Ricardo’s forecasting ability.

In judging any forecast for the current year, please consider the problems Ricardo’s own broker had in forecasting last year’s outcome:

<table>
<thead>
<tr>
<th>James Capel’s forecasts for the year June 1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date of forecast</td>
</tr>
<tr>
<td>Sep 1986</td>
</tr>
<tr>
<td>Feb 1987</td>
</tr>
<tr>
<td>Jun 1987</td>
</tr>
<tr>
<td>10 Feb 1988</td>
</tr>
<tr>
<td>17 Feb 1988</td>
</tr>
<tr>
<td>Actual</td>
</tr>
</tbody>
</table>

Racal Electronics (example 53) used third party forecasts to attack the business of the other side.

Williams sales of fire protection equipment to the civil aviation market are exposed to the forecast decline in aero engine deliveries.

Notes (extract)

Conclusions

This chapter shows how management uses financial disclosures to persuade shareholders to support their position. Efforts to persuade are considerable and are not often seen in other financial reporting contexts.

Where companies did not disclose a forecast, they often included justification for such non-disclosure. Shareholders might otherwise assume that the absence of the forecast was due to likely poor results.

Apart from using profit forecasts to persuade shareholders, management uses alternative, vaguer statements (often in the Current trading and prospects section of the takeover document) to give an impression or indication of results without making a formal profit forecast. Data from third parties (often brokers'/analysts’ forecasts) are also used in lieu of forecasts, as are dividend forecasts.

Many companies are attacked when they do not disclose a forecast, with the underlying suggestion from the attacker that non-disclosure means that poorer results are likely. The attacks on forecasts published by the other party to the bid, confirms the suggestion that the audience for these disclosures is not restricted to shareholders and that management of the other party carefully reads and analyses disclosures in the forecast. These attacks may be brought to the attention of the media and can be made public and have a strong adverse public relations effect.
7. Conclusions

This study analysed financial reporting practices relating to profit forecasts disclosed in takeover documents. The regulatory context of the research - legal, institutional and professional regulations - governing publication of profit forecasts in the UK were summarised.

Examples from profit forecasts and takeover documents were derived from a systematic analysis of the disclosure practices in 250 profit forecasts disclosed during 701 public company takeover bids in the UK in the period 1988 to 1992. There were 74 cases selected from the 250 forecasts to illustrate particular practices which are the subject of comment and discussion.

The analysis of disclosures of financial items in profit forecasts illustrated the wide variety of current disclosure practice.

The analysis of examples provided some evidence of strategic information disclosures by management. Nearly all instances of change in accounting policy improved forecast results suggesting systematic upward adjustment of profits. Further evidence of strategic choices by managers is provided in respect of items ‘forecast’ but not treated as a forecast and therefore not reported on by reporting accountants and financial advisors to the company.

A wide variety of assumptions are disclosed in profit forecasts. Careful reading of the assumptions in forecasts is essential. Some (especially company-specific assumptions) create considerable uncertainty as to the reliability of the forecast. In some cases, the assumptions seem to be used cynically by management to provide protection to management if the forecast is not subsequently achieved. These assumptions seem to serve management’s own self-interest possibly at the expense of shareholders.

Examples of the use of financial disclosures to persuade shareholders to support management’s position were shown. Efforts to persuade are considerable and are not often seen in other financial reporting contexts. Alternatives to profit forecasts were also used to persuade shareholders.

Attacks on forecasts published by the other party to the bid, confirms the suggestion that the audience for these disclosures is not restricted to shareholders and that management of the other party carefully reads and analyses disclosures in the forecast. These attacks may be brought to the attention of the media and can be made public and have a strong adverse public relations effect.
Issues for policy makers

Current regulations allow considerable flexibility and choice in the items, the assumptions and level of detail to be disclosed in relation to profit forecasts. The analysis of examples shows that this flexibility is taken advantage of in practice and considerable variability in the quality of disclosures was found, especially in their reliability and objectivity. The analysis has shown that this flexibility is used by management to influence shareholders’ understanding of the company. This would suggest that considerable tightening of regulations is called for to limit or restrict the flexibility allowed to protect shareholders from misleading information.

US professional regulations, unlike those in the UK, specify minimum disclosure in forecasts. Similar provisions in the UK would result in greater consistency in the forecast items disclosed between companies.

Consideration might be given to expanding the role of the reporting accountants and financial advisors to requiring them to consider the objectivity of the messages and information in takeover documents. Similar recommendations might be made to those in the *Operating and Financial Review* (Accounting Standards Board, 1993), which requires, *inter alia*, that operating and financial reviews should be balanced and objective and should refer to comments or statements made in previous documents published by the company.
References


