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Accountants' Reports on Profit Forecasts: Regulation and Practice

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Accountants' Reports on Profit Forecasts: Regulation and Practice

Abstract

Profit forecasts are rarely disclosed in the UK except in prospectuses, circulars and during takeover bids. There are few regulations governing the content of profit forecasts. 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.

This paper summarises the regulations, including professional pronouncements, governing accountants' reports on profit forecasts. Practical examples of such accountants' reports extracted from 250 profit forecasts published during 701 UK takeover bids in the period 1988 to 1992 are reproduced and discussed. These examples provide useful precedent material for practitioners involved in reporting on a profit forecast. The paper concludes with a discussion of policy issues and suggestions for policy makers.

Keywords: Accountants' reports, profit forecasts, takeovers

1. 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 may be 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. There are few regulations governing the content of profit forecasts. 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 (Brennan and Gray, 1998; forthcoming 2000).

The purpose of this paper is to report a comprehensive, in-depth survey of accountants' reports on profit forecasts in the UK during a five year period 1988 to 1992. Although the examples are somewhat dated they are as relevant today as when they were published because the regulations governing accountant's reports have changed little in the intervening period. Thus, these examples act as useful precedent material for practitioners having to prepare such reports.

This section has introduced the context in which accountants report on profit forecasts in the UK. The regulatory environment governing accountants' reports is summarised in section 2. The data on which the research is based, and the research methodology, is outlined in Section 3. Section 4 reports a comprehensive, in-depth survey of accountants' reports on profit forecasts, and the wording therein. This paper analyses and discusses these reports, illustrating the discussion with 25 examples extracted from accountants' reports on profit forecasts.

2. REGULATIONS

Both the Stock Exchange's Listing Rules ('*yellow book*') (London Stock Exchange, 1997) and the Takeover Panel's City Code (Panel on Takeovers and Mergers, 1998) require published profit forecasts to be reported on by company auditors or reporting accountants. The regulations do not require an audit of the forecasts and many reporting accountants emphasise this in their report.

2.1 Stock Exchange regulations

The Stock Exchange's Listing Rules (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. Paragraphs 12.21 to 12.27 deal with profit forecasts.

The auditors/reporting accountants and the financial advisors/sponsors must report on any profit forecast or estimate of results published. 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.'*

2.2 City code on takeovers and mergers

The City Code (Panel on Takeovers and Mergers, 1998) is based on a number of general principles together with a series of rules expanding on the general principles. In addition, notes are provided giving more detailed practical guidance on the application of some rules.

Rule 28.3 of the City Code deals with reports required in connection with profit forecasts. No report is required in cash only offers (Rule 28.3(a)). For any forecast 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.*'(Rule 28.3. (b)). Under Rule 28.4, the reports must be included in documents containing forecasts. The reports must be accompanied by a statement that those making the reports have given and not withdrawn their consent to publication.

Many of the notes to rule 28 provide additional practical guidance on the preparation of, and reporting on, profit forecasts. The auditors/reporting accountants are required to '*satisfy themselves that the forecast, so far as the accounting policies and calculations are concerned, has been properly compiled on the basis of the assumptions made.*' The notes on rule 28.2 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 assumptions that appear unrealistic to be published or assumptions to be omitted that appear to be important. Otherwise they are required to make appropriate comment in their report.

The requirements of the '*Yellow Book*' and the City Code are somewhat different. The '*Yellow Book*' requires the reporting accountant to ensure that the forecast has been '*properly compiled on the basis stated*' and that it is '*consistent with the accounting policies of the company*'. The City Code, on the other hand, requires the reporting accountant to examine and report on '*the accounting policies and calculations for the forecast*'.

2.3 Professional guidance

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 (ICAEW), 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. The technical statement (ICAEW, 1978) deals with the reporting accountants' work under three headings:

Preliminary considerations

The reporting accountants are advised to agree the following with the directors before accepting the assignment:

- Purpose for which the forecast (and accountants' report) is required;
- That the forecast, and particularly the assumptions on which the forecast is based, is the directors' responsibility;
- Period covered by the forecast;
- That there are no material restrictions on the scope of the reporting accountants' work;
- Time available for the assignment is adequate.

Review of profit forecasts

The main matters to be considered by the reporting accountants in carrying out their review are:

- Nature and background of the company's business;
- Accounting policies normally followed by the company (and that they were consistently applied in the forecast);
- Whether the forecast is consistent with, and has been properly compiled given the assumptions on which it is based. The technical statement emphasises that reporting accountants are not responsible for the assumptions but will need to consider whether any assumptions are unrealistic;
- Procedures followed by the company in preparing the profit forecast.

The accountants' report

The accountants' report should be addressed to the directors and should include reference to the following five items:

- Specific identification of the profit forecast and documents to which the report refers;
- That the directors are solely responsible for the forecast;
- That the accounting policies and calculations in arriving at the forecast have been examined;
- Where appropriate, a statement that no audit has been carried out;
- The reporting accountants' opinion that the forecast has been properly compiled on the basis of assumptions made by the Board, consistent with the accounting policies normally adopted.

In November 1990, an exposure draft of an auditing guideline was issued which was not progressed (ICAEW, 1990). It provided detailed guidance on the work to be performed by accountants in reporting on forecast information. Statement of Investment Circular Reporting Standard No. 100 '*Investment Circulars and Reporting Accountants*' was issued in December 1997 (Auditing Practices Board, 1997). It establishes standards and provides guidance on the general principles governing reporting accountants' engagements in relation to investment circulars. This statement covers accountants' reports on profit forecasts/estimates.

Carter and Morland (1978) and Deloitte Haskins & Sells (1984) outline detailed procedures that should be followed in an examination of profit forecasts.

3. POPULATION AND SELECTION OF SAMPLE

The sample chosen for study covers all takeover bids for companies listed on the London Stock Exchange during the 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. This includes takeovers of UK and Irish public companies by other UK and Irish public companies, by unlisted UK companies and by listed and unlisted foreign companies.

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 from the study, 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 includes the full population of 701 bids (involving 1,402 bidders and targets) for the period. 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.

4. EXAMPLES OF ACCOUNTANTS' REPORTS

This paper reproduces 25 examples taken from the 250 accountants' reports in the sample. The Appendix lists each example, with details of the reporting accountants, clients and takeover bid. The examples are listed alphabetically by reporting accountant.

4.1 Standard wording in accountants' reports

The technical statement '*Accountants' Reports on Profit Forecasts*' (ICAEW, 1978) specifies five items that must be referred to in accountants' reports. These are listed in paragraph 2.3.

Price Waterhouse's report (Example 1) on Reed International is an example of the fairly standard wording used in most accountants' reports. This report refers to four of the five items listed in paragraph 2.3 (there is no statement about an audit not having been carried out).

Example 1: Standard wording in accountants' report

We have reviewed the accounting policies and calculations for the forecasts of profit before tax and earnings per share (together "the forecasts") of Reed International P.L.C. ("Reed") and its subsidiaries (together "the Group") for the twelve months ending 31 December 1992 set out on page 38 of the document dated 30 October 1992 addressed to the shareholders of Reed and to the holders of shares and of Bearer Depository Receipts in Elsevier NV.

The forecasts, for which the Directors of Reed are solely responsible, include results shown by unaudited management information for the nine months ended 30 September 1992 and forecasts for the three months ending 31 December 1992.

In our opinion, the forecasts, so far as the accounting policies and calculations are concerned, have been properly compiled on the basis of the assumptions made by the Directors of Reed, set out on page 38 of the said document, and are presented on a basis consistent with the accounting policies normally adopted by the Group.

4.2 Other wording in accountants' reports

Grant Thornton's report (Example 2) goes into more detail than most. In addition to reporting on the forecast, they state that they '*reviewed the trading agreement between Courage Limited and Morland*' as this agreement relates to the forecast.

Example 2: More detailed accountants' report

We have also reviewed the trading agreement between Courage Limited and Morland in respect of which the Directors of Morland have estimated profits before taxation in excess of £800,000 and earnings per share of at least 2.5p to arise in the first full year of operation. This estimate, for which the Directors of Morland are solely responsible, is set out on page 10 of the Circular. In our opinion this estimate has been prepared on a basis consistent with accounting policies normally adopted by Morland and has been properly compiled after due and careful enquiry.

Coopers & Lybrand Deloitte's report (Example 3) is cautiously worded as to the likely outcome of the forecast. They do not express an opinion '*as to how closely the*

results eventually achieved will compare with the projections'. In addition to stating that the calculations are *'properly compiled'*, the accountants also say that the calculations are *'mathematically accurate'*. The distinction between these two phrases is not clear but the latter wording seems to further limit the accountant's responsibility for the forecast.

Example 3: Cautiously worded accountants' report

- (i) We have reviewed the accounting policies and calculations for the illustrative financial projection ("the projections") of Magnetic Materials Group plc ("MMG") and its subsidiaries ("the Group") for the year ending 30th June, 1992 as set out on page 13 of the circular dated 21st June, 1991 addressed to the shareholders of MMG.

The projections, for which the directors of MMG ("the Board") are solely responsible, have been prepared on the basis of the assumptions set out in the said circular. It should be appreciated that the projections and the assumptions on which they are based has been prepared solely for the purposes of illustration and do not constitute forecasts of the future results of the Group.

In as much as the projections and the assumptions on which they are based relate to the future, we express no opinion as to how closely the results eventually achieved will compare with the projections.

We confirm that, in preparing the projections, the assumptions have been properly applied in accordance with the accounting policies adopted by the Group and that the calculations are mathematically accurate.

- (ii) We have reviewed the estimate of the effect of measures proposed by the Board to enhance the profitability of the Group which is set out on page 13 of the circular dated 21st June, 1991, addressed to the shareholders of MMG.

In our opinion this estimate, so far as the accounting policies and calculations are concerned, has been properly compiled on the basis of the proposals made by the Board set out on page 13 of the circular, and is presented on a basis consistent with the accounting policies normally adopted by the Group.

4.3 Involuntary forecasts

With one exception, the City Code does not compel directors to make a forecast. Rule 28.6 (b) 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 this rule. Tomkins' forecast was made involuntarily as Arthur Andersen's report (example 4) clearly points out.

Example 4: Accountant's report on involuntary forecast

We refer to the statement 'The Board of Tomkins remains confident that, subject to unforeseen events, Tomkins will perform in line with its objectives despite the adverse conditions' made by the Chairman of Tomkins PLC ("Tomkins") at the AGM on 17 September 1992 in respect of trading in the year ending 1 May 1993.

Under the City Code on Takeovers and Mergers, this statement, taken together with Tomkins objectives as set out in the Annual Report of Tomkins PLC and subsidiaries (the "Tomkins Group") for the year ended 2 May 1992, has been deemed by the Panel on Takeovers and Mergers to be a forecast that basic and fully diluted earnings per ordinary

share for the year ending 1 May 1993 will exceed basic and fully diluted earnings per ordinary share for the year ended 2 May 1992.

We have reviewed the accounting policies applied and the calculations made to support this deemed forecast for which the Directors of Tomkins are solely responsible. The principal assumptions made by the Directors upon which such forecast is based are set out on page 26 of the Listing Particulars dated 9 November 1992. Such forecast includes results shown by unaudited interim accounts for the period ended 31 August 1992.

In our opinion such forecast so far as the accounting policies and calculations are concerned has been properly compiled on the basis of the assumptions made by the Directors of Tomkins and is prepared on a basis consistent with the accounting policies normally adopted by the Tomkins Group.

The letter (Example 5) in relation to William Sommerville's forecast is more abbreviated than the standard accountants' report. This may be because the forecast being reported on was being made involuntarily. Also, typical of involuntary forecasts, the forecast is a narrative statement and is not quantified.

Example 5: Abbreviated accountants' report

We have considered the contents of the "Directors' Report" attached to the unaudited statement of the interim results for the six months to 30th November, 1988, which appears on pages 19 and 20.

We confirm after due and careful enquiry that the forecast made by the Directors that "we will not match last year's record profits" was properly made.

4.4 Profit 'estimates'

Profit 'estimates' are published estimates for a period expired made in advance of completion of the financial statements. Rule 28.6 (c) of the City Code requires these to be reported on in the same way as profit forecasts. T. Cowie made a forecast for the six months ending 30 June 1992. This forecast was published on 3 July 1992, after the forecast period end, and was therefore called an 'estimate' (Example 6).

Example 6: Report on profit 'estimate'

We refer to the profit estimate of T. Cowie P.L.C. (for which the directors are solely responsible) for the six months ended 30th June 1992, set out in the Offer document and accompanying Listing Particulars, dated 3rd July 1992.

We have reviewed the management accounts of T. Cowie P.L.C. for the five months ended 31st May 1992 and an estimate of the results for the ensuing month. On the basis of this review, which did not constitute an audit, we report that in our opinion the profit estimate has been properly prepared from the management accounts and estimate on a basis consistent with the accounting policies normally adopted by T. Cowie P.L.C.

Peat Marwick McLintock's report (Example 7) on Molins' interim results is similar in wording to accountants' reports on profit forecasts. Under the rules of the Takeover Code the interim results are deemed to be estimates that must be reported on. The

interim results are for a period ending 30 June 1989. The results had not been audited by the dated of the takeover document (18 August 1989) and the interim results are therefore referred to as estimates. Similar to many 1989 forecasts, the accounting policy on pensions changed on adoption of SSAP 24.

Example 7: Accountants' report on interim results

In accordance with our instructions, we have reviewed the accounting policies and calculations used in preparing the unaudited statement of profit before and after taxation, incorporated in the interim results of Molins PLC and its subsidiary companies (the "Group) (for which the Directors are solely responsible) for the period ended 30th June, 1989, set out on pages 7 and 8 of the circular dated 18th August, 1989, addressed to the shareholders of Molins PLC. The statement is based on the unaudited management accounts for that period.

Our review was substantially less in scope than an audit and consequently we express no opinion as to whether the figures included in the statement give a true and fair view of the profit for the period ended 30th June, 1989. However, so far as the accounting policies and calculations are concerned, in our opinion, the statement has been properly compiled by the Directors from the management accounts referred to above and is presented on a basis consistent with the accounting policies normally adopted by the Group and its subsidiary companies except for changes necessary to those policies as a result of Statement of Accounting Practice 24, as described on pages 7 and 8 of the circular.

The results relating to Oilfield Inspection Services published on 1 March 1988 are for a period expired i.e. for the period ended 31 December 1987. Consequently the term 'estimate' is used in the accountant's report (Example 8). Most accountants' reports emphasise that the forecast is the directors' responsibility. Peat Marwick McLintock's report on Oilfield Inspection Services' forecast is unusual in that two named directors are excluded from responsibility for the forecast.

Example 8: Exclusion of directors from responsibility for the forecast

We have reviewed the accounting policies and calculations for the estimates of loss before taxation, loss after taxation and loss per ordinary share of Oilfield Inspection Services Group plc and its subsidiaries ("OIS") for the year ended 31st December, 1987. The estimates of loss and loss per share, for which the directors of OIS, other than Mr. Oates and Mr. Yates, are solely responsible, are set out on page 5 of the circular to OIS shareholders dated 1st March, 1988 ("the circular").

In our opinion the estimates of loss and loss per share, so far as the accounting policies and calculations are concerned, have been properly compiled on the bases and assumptions made by the directors, other than Mr. Oates and Mr. Yates, as set out on page 6 of the circular and are presented on a basis consistent with OIS's accounting policies.

4.5 Projections

Some companies include projections of profit as opposed to forecasts of profit. The distinction between these two terms is not always clear. The auditing guideline exposure draft *Prospective Financial Information* (ICAEW, 1990) defined a forecast as:

‘management’s best expectation of the most likely future results, financial position or changes in financial position of an enterprise for one or more future dates or periods based on assumptions representing management’s judgement of both the conditions likely to prevail and the course of action it is most likely to take. Due to the need for reliability a forecast should only exceptionally extend beyond the current accounting period.’

A projection, on the other hand, is defined as either:

- (a) management’s best expectation of the future results, financial position or changes in financial position which is subject to more uncertainty than a forecast because of the quality of the corroborative evidence available to support the amounts. This could be due to such factors as:
 - how far ahead the future period is;
 - lack of sufficient trading record;
 - volatility of the business;
 - especially uncertain business environment; and
 - highly subjective assumptions; or
- (b) management’s illustration of the future results, financial position or changes in financial position based on hypothetical assumptions which may or may not prevail over the period but which are nevertheless within a reasonable range.’

Projections often cover a period not yet underway and refer to the post-takeover period. In Example 9, Ernst and Young report on four different financial statements of Ultramar: (i) the forecast for the year ended 1991; (ii) the forecast for the year ended 1992 (iii) the projection for 1992 and (iv) the group projection for 1992. Ernst and Young are at pains to point out that the two projections should not be regarded as forecasts. It is likely that most (even sophisticated) readers would not understand the distinctions being made.

Additional guidance on this issue is provided in the 1998 edition of the City Code (compared with previous editions in force when Ultramar made its forecasts / projections). 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 a profit forecasts.

Example 9: Accountants' report on projection 'not a forecast'

We have reviewed the accounting policies and calculations applicable to the 1991 Forecast, as set out and defined in Appendix III to the circular dated 28th November, 1991 (the "Circular") from Ultramar to its shareholders, for which the Directors of Ultramar are solely responsible. It is based on the unaudited nine months results for the period to 30th September, 1991, unaudited management accounts for October 1991, and management estimates for the remaining period.

We have reviewed the accounting policies and calculations applicable to the 1992 Forecast, as set out and defined in the Circular, for which the Directors of Ultramar are solely responsible. It is based on management forecasts in respect of the upstream businesses, group items, minorities and exceptional items.

We have reviewed the accounting policies and calculations applicable to the 1992 Projection, as set out and defined in the Circular, for which the Directors are solely responsible. It is based on management projections for interest and for the downstream businesses, as more normal business conditions return. We have also reviewed the aggregation of the 1992 Forecast and the 1992 Projection, which together comprise the 1992 Group Projection. We emphasise that the 1992 Projection and the 1992 Group Projection should not be regarded as forecasts. They have been prepared to illustrate the possible results of the Group as more normal business conditions return. Events and circumstances frequently do not occur as originally expected and attention is drawn, in particular, to the risk factors referred to in paragraph 3 of Appendix III to the Circular. The actual results may therefore differ materially from those projected.

In our opinion, the 1991 Forecast, the 1992 Forecast, the 1992 Projection and the 1992 Group Projection, so far as the accounting policies and calculations are concerned, have been properly compiled on the basis of the assumptions made by the Directors, as set out in paragraphs 1(b) and 2(b) of Appendix III to the Circular, and are presented on bases consistent with the accounting policies normally adopted by the Group, except for the changes of accounting policy with regard to the translation of foreign currency earnings into sterling and the treatment of ACT described in paragraphs 1(a) and 2(a) of Appendix III to the Circular.

4.6 Accountants' report not an audit

The three examples below refer to the work done on the forecasts as being a 'review' (in other words, not an audit). Peat Marwick McLintock indicate that their report (Example 10) does not give an opinion on whether the forecast gives a true and fair view of results as the work done was '*substantially less in scope*' than an audit.

Example 10: Accountants' report not an audit

Our review was substantially less in scope than an audit and consequently we express no opinion as to whether the estimate gives a true and fair view of the results for the half year. However, so far as the accounting policies and calculations are concerned, in our opinion the estimate has been properly compiled by the Directors from the management accounts and other data referred to above and is presented on a basis consistent with the accounting policies normally adopted by the Company and its subsidiaries.

Brebner, Allen and Trapp (Example 11) use unusual wording to indicate that the work done on the forecast did not constitute an audit. They emphasise that the scope of the review was restricted.

Example 11: Accountants' report not an audit

Such a review being restricted in scope, would not necessarily disclose all relevant matters which would have otherwise been disclosed by an examination made in accordance with approved Auditing Standards.

Within the limitations of our review, we have formed the opinion that the said unaudited financial information, for which the Directors of EPIC are solely responsible, has been properly compiled by them on the basis of the accounting policies normally adopted by EPIC and its subsidiaries.

Coopers & Lybrand Deloitte's draw attention (Example 12) to a specific area not subject to audit by specifying that the work done '*did not incorporate a full assessment of the valuation of stocks and debtors*'. This makes one wonder whether they had special concerns about the valuation of these two assets in particular. In addition, the reporting accountants use a wording ('*Subject to the matter referred to in the paragraph above*') arising from the review not being an audit which seems to derive from audit report terminology.

Example 12: Accountants' report not an audit

We refer to the estimate of results for Kingsgrange plc ("Kingsgrange") and its subsidiaries (the "Group") for the year ended 30 April 1991 which is set out in Appendix IV of the Offer document dated 11 June 1991 addressed to the shareholders of Kingsgrange.

We have reviewed the management accounts of Kingsgrange and its principal subsidiaries for the year ended 30 April 1991. Our review was not carried out in accordance with auditing standards and did not constitute an audit and, in particular, the management accounts did not incorporate a full assessment of the valuation of stocks and debtors.

Subject to the matter referred to in the paragraph above, in our opinion, the estimate referred to above, for which the Directors of Kingsgrange are solely responsible, has been properly compiled from the management accounts of the companies in the Group on a basis consistent with the accounting policies normally adopted by the Group.

4.7 Basis of compiling forecasts

Most forecasts refer to the basis on which the forecast is made. Arthur Young's report (Example 13) is more detailed than average on the basis for making the Iceland Frozen Foods' forecast. It states that the forecast (i) is based on management accounts and directors' estimates, (ii) is based on the assumptions made by the directors and (iii) is based on consistent accounting policies.

Example 13: References to basis of forecast

The sales and profit forecasts, which has been prepared under the historical cost convention, include the results of the Group based on unaudited management accounts for the thirty nine weeks ended 1st October, 1988 and directors' estimates for the remainder of the financial year.

In our opinion, the sales and profit forecasts, so far as the accounting policies and calculations are concerned, have been properly compiled on the basis of the assumptions made by the Directors set out in Part 4 of the Listing Particulars on bases consistent with the accounting policies normally adopted by the Group.

Peat Marwick McLintock (Example 14) explain in detail how the forecasts of Chalford Communications' associated companies were prepared. The accountants state that the board of Chalford Communications '*did not consider it appropriate to request the boards of each of the associated companies to approve that element of the Chalford Group profit forecast relating to its associated company*'. This statement creates some uncertainty as to the reliability of the forecast.

Example 14: References to basis of making the forecast

The forecast results for the associated companies have been prepared by the board of Chalford Communications Limited. The board of Chalford Communications Limited did not consider it appropriate to request the boards of each of the associated companies to approve that element of the Chalford Group profit forecast relating to its associated company. The forecast was prepared taking into account:-

- (a) the operating budgets for the year ending 30th September, 1988, approved by the boards of the associated companies;
- (b) the results of the associated companies as shown by their management accounts for the six months ended 31st March, 1988. The management accounts of London Broadcasting Co. (Holdings) limited for the six months ended 31st March, 1988, which represents 53.4 per cent. of the profits of the associated companies for the six months, have been audited; the results of the other associated companies have not been audited;
- (c) other information available to the Board of Chalford Communications Limited, through their representation on the boards of the associated companies.

Profits and losses on the disposal of those investments not treated as associated companies are included, as an exceptional item, in profits before taxation and extraordinary items.

In our opinion the Chalford Group profit forecast, so far as the accounting policies and calculations are concerned, has been properly compiled on the footing of the assumptions made by the board of Chalford Communications Limited, set out in this document, and is presented on a basis consistent with the accounting policies normally adopted by the Chalford Group.

4.8 Accounting policies not consistent

It is not uncommon to find that companies making profit forecasts also change their accounting policies. In example 9 earlier, the reporting accountants, Ernst and Young, highlight two changes in accounting policy by Ultramar. The accounting policy for translation of foreign currency earnings and the treatment of Advance Corporation

Tax (ACT) were changed when making the forecast. No justification for the change is offered by Ernst and Young – there was no change in accounting standards at that time that might have caused the change in accounting policy.

Ernst & Whinney (Example 15) draw attention to AGB Research's change in accounting policy regarding finance leases. No indication is given in their report as to why the accounting policy changed. No reason is given in the forecast (not reproduced here) for the change which, however, is stated to have no material effect on the profit estimates.

Example 15: Reference to change in accounting policy

In our opinion, the estimates of profit before taxation and extraordinary items, so far as the accounting bases and calculations are concerned, have been properly compiled on the bases and assumption set out in Part III of the Listing Particulars and are prepared on a basis consistent with the accounting policies normally adopted by the Group except for the change in accounting policy regarding finance leases. The estimate of earnings per ordinary share has been properly calculated.

Price Waterhouse (Example 16) draw attention to a change in accounting policy but justify the change as arising from adoption of SSAP 24 for the first time.

Example 16: Reference to change in accounting policy

In our opinion the forecast, so far as the accounting policies and calculations are concerned, has been properly compiled on the footing of the assumptions made by the Directors set out on page 18 of the Document and is presented on a basis consistent with the accounting policies normally adopted by the Group with the exception that SSAP 24, Accounting for Pension Costs, has been adopted with effect from 1 January 1989.

Two accounting policies changed in preparing United Scientific's profit forecasts. The wording used in Ernst and Young's report (Example 17) indicates that both changes arise from changes in accounting standards.

Example 17: Reference to change in accounting policy

In our opinion, the estimates, so far as the accounting policies and calculations are concerned, have been properly compiled on a basis consistent with the accounting policies normally adopted by the Group except for changes necessary to those policies as a result of Statement of Standard Accounting Practice Number 24 as described on page 5 of the circular. In addition, the Group's previous policy on turnover has been extended in accordance with Statement of Standard Accounting Practice Number 9 (Revised) to reflect the fact that turnover includes a prudent assessment of the value of work completed on major long term contracts.

The wording used by Price Waterhouse (Example 18) (*‘Without qualifying the opinion expressed in the foregoing paragraph, we draw your attention to’*) in referring to Highland Electronic’s change in accounting policy to write off development expenditure as incurred is different to other examples. This form of wording is similar to that which would be used in an audit report.

Example 18: Reference to change in accounting policy

On the basis of this review, which did not constitute an audit, in our opinion the estimates of profit before taxation and of extraordinary charges, so far as the accounting policies and calculations are concerned, have been properly compiled on a basis consistent with the accounting policies normally adopted by the Highland Group other than as described in the following paragraph.

Without qualifying the opinion expressed in the foregoing paragraph, we draw your attention to the change in accounting policy referred to in paragraph 2 of Part VII of the Listing Particulars. In preparing the financial information on the Highland Group in Part V of the Listing Particulars and the estimate the (sic) Highland Group’s profit before taxation for the year ended 30th April 1990 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.

4.9 Limitations in accountants’ report

Price Waterhouse say in their report (Example 19) that they did not review the actuarial bases, assumptions and calculations relating to the change in embedded value. Presumably this is because there is a separate report from the actuaries on this aspect of the forecast.

Example 19: Accountants’ report limited

The combined profit forecasts include the forecast change in the embedded value of the long-term assurance business of Black Horse Life Assurance Company Limited for the year ending 31 December 1988 which has been the subject of a separate letter by Bacon & Woodrow, consulting actuaries, a copy of which is set out on pages 26 and 27 of the circular. We have reviewed the accounting bases and the underlying accounting data used in the calculation of the change in the embedded value of the long-term assurance business but have not reviewed the actuarial bases, assumptions and calculations.

In our opinion the combined profit forecasts, so far as the accounting policies and calculations are concerned, have been properly compiled on the footing of the assumptions made by the Directors set out on page 26 of the circular and are presented on a basis consistent with the accounting policies normally adopted by the Lloyds Bank Group.

Clark Whitehill’s report (Example 20) on Pearl is similar in not examining the adjusted embedded value profit estimate. This, the accountants indicate, is subject to a separate report from the actuaries. The accountants also refer to a change in accounting policy on adoption of SSAP 24.

Example 20: Accountants' report limited

(a) Aggregate Profit Forecast (extract)

In our opinion, the Non-Life Profit Forecast, so far as the accounting policies and calculations are concerned, has been properly compiled on the bases and assumptions made by the Directors referred to in Appendix II of the Circular and on a basis consistent with the accounting policies normally adopted by the Group, subject to the adoption of Statement of Standard Accounting Practice No. 24 "Accounting for pension costs" ("SSAP 24"), which will apply to Pearl for the first time this year.

We have not reviewed the Adjusted Embedded Value Profit Forecast, which is the subject of a separate letter from Tillinghast, a copy of which is set out in Appendix II of the Circular. We have reviewed the accounting policies and the accounting data supplied for the calculations of the Adjusted Embedded Value Profit Forecast, but not the actuarial bases, assumptions and calculations.

In our opinion, the accountings policies referred to above are consistent with those normally adopted by Pearl, subject to the application of SSAP 24.

We confirm that the Non-Life Profit Forecast and the Adjusted Embedded Value Profit Forecast have been properly combined to produce the Aggregate Profit Forecast after tax for the year ending 31st December 1989.

Price Waterhouse (Example 21) seem to distance themselves from Peachey Property's estimates of gross rental income. Firstly they state that the estimates are based on values provided by other professional advisors. They go on to express reservations on the reliability of the estimates – '*we do not express or imply any opinion as to the likelihood of their achievement*'. Similar to example 12 earlier, the reporting accountants use the '*subject to*' phrase in giving their opinion on the forecast.

Example 21: Qualified accountants' report

We have reviewed the calculations for the estimates of gross rental income of Peachey Property Corporation plc and its subsidiaries (for which the Directors are solely responsible) for the five years ending 24th June, 1993 set out on page 7 of the document dated 25th August, 1988. The estimates of gross rental income are based upon estimated rental values as at 24th June, 1988 provided by Healey & Baker and Jones Lang Wootton, chartered surveyors.

The estimates of gross rental income cover an extended future period for which there are inherent risks. They should not be regarded as firm forecasts and we do not express or imply any opinion as to the likelihood of their achievement.

Subject to the foregoing, in our opinion the estimates of gross rental income so far as the calculations are concerned, have been properly compiled on the footing of the assumptions made by the Directors set out on page 7 of the document referred to above.

4.10 'Qualified' accountants' reports

KPMG Peat Marwick McLintock qualify their report (Example 22) on Caird's forecast. They state their disagreement with the inclusion of £1.5 million profit arising on sale of the properties which, the auditors state, should be treated as a revaluation reserve. The phrase '*with this exception*' is used to indicate their qualification.

Example 22: Qualified accountants' report

In our opinion the profit of £1.5 million arising on sale of the properties referred to in note (b) (i) on page 9 of the circular should be treated more properly as a revaluation surplus rather than being recognised as profit. With this exception in our opinion the forecast, so far as the accounting policies and calculations are concerned, has been properly compiled on the basis of the assumptions made by the Directors set out on page 10 of the circular and is presented on a basis consistent with the accounting policies normally adopted by Caird.

4.11 Pro-forma forecasts

As well as providing individual company forecasts, some companies produce forecasts for the combined group after the takeover. The accountants' reports on two pro-forma forecasts are shown below. The accountant's report (Example 23) on Hunting Gibson describes very clearly how the pro-forma forecast was prepared and the adjustments necessary in combining three separate forecasts.

Example 23: Accountants' report on pro-forma forecast

The pro forma profit forecast for the year ending 31st December, 1989, set out in Part VI of the Listing Particulars, combines the separate profit forecasts of HG, HAI and HPS as if they had been part of one group since 1st January, 1989 and incorporates such adjustments as are necessary to eliminate the effects of the holdings of HG in the Ordinary Shares and Convertible Loan Stocks of HAI and HPS and of HAI in the Ordinary Shares of HPS and to reflect the consequences of the Offers, all of which are set out in Part VI of the Listing Particulars. The accounting policies used in the preparation of the profit forecasts of HG, HAI and HPS are consistent and no adjustments are therefore necessary when combining these forecasts. We have been informed by the proposed Directors of Hunting Gibson plc (to be re-named Hunting plc) that the accounts for the year ending 31st December, 1989 will be prepared using accounting policies and bases consistent with those used in preparing the aforementioned profit forecast.

In our opinion the pro forma forecast has been properly prepared on the bases set out above, using consistent accounting policies and on the assumptions made by HG, HAI and HPS, set out in Part VI of the Listing Particulars.

The explanations given in the accountant's report (Example 24) in respect of the pro forma forecast for Reed Elsevier are less elaborate.

Example 24: Report on combined forecast

We have reviewed the Combined Pro Forma Financial Information and accompanying bases of preparation as defined and set out in Appendix 3 of the document dated 30 October 1992 addressed to the holders of shares and of Bearer Depository Receipts in Elsevier NV and to the shareholders of Reed International P.L.C.

In our opinion, the Combined Pro Forma Financial Information, so far as the calculations are concerned, has been properly compiled on the bases of preparation set out in Appendix 3 of the said document.

4.12 Accountants' reports on dividend forecast

Accountants' rarely report on dividend forecasts. In this research, although many dividend forecasts were found in the sample, only one was accompanied by an accountant's report. Paragraph 12.23 of the *Listing Rules* (London Stock Exchange, 1997) states that '*A dividend forecast must be treated as a profit forecast where the issuer has a known policy of relating dividends to earnings, or has an insufficient level of retained earnings or the forecast otherwise implies a forecast of profit*'. In the case of ASIT Investment Trust, the directors stated in the dividend forecast (not reproduced) that payment of the forecast dividend is '*subject to the availability of distributable reserves, which the directors believe will be sufficient*'.

Example 25: Accountants' report on dividend forecast

We have reviewed the accounting policies and calculations used in preparing the dividend forecast of A.S.I.T. Investment Trust PLC and its subsidiaries (together "the Group") for the year ending 30th September, 1992 ("the dividend forecast"), for which the Directors of A.S.I.T. Investment Trust PLC are solely responsible, set out in the Listing Particulars dated 1st November, 1991.

In our opinion, the dividend forecast, so far as the accounting policies and calculations are concerned, has been properly compiled on the basis of the assumptions made by the Directors of A.S.I.T. Investment Trust PLC and is presented on a basis consistent with the accounting policies normally adopted by the Group.

5. Summary and conclusions

The paper has reproduced and discussed examples taken from 25 accountant's reports extracted from a study of 250 profit forecasts. Although the examples are somewhat dated they are as relevant today as when they were published because the regulations governing accountant's reports have changed little in the intervening period. Thus, these examples act as useful precedent material for practitioners having to prepare such reports.

5.1 Issues for policy makers

Although the wording and phraseology in many accountants' reports are fairly standard, some of the examples show interesting variations on the standard wording to cope with particular circumstances. The extent to which accountants include limiting paragraphs, and express reservations and limitations in their reports, indicates the nervousness with which they make such reports. It is likely that, in a takeover

situation, they perceive the risks involved in making such reports (i.e. the chances of being sued) as greater than in a normal annual audit.

There is evidence that current guidance on the wording to be used in accountants' reports is inadequate, especially where some qualification or limitation is called for. Some of the examples contained phraseology derived from guidelines on the wording to be used in audit reports. In Example 12 the phrase '*Subject to the matter referred to in the paragraph above, in our opinion...*' was used. The phrase '*Subject to the foregoing, in our opinion...*' is seen in Example 21. Example 22 is clearly a qualified report and the reporting accountants use the phrase '*With this exception in our opinion...*'.

The Auditing Practices Board (1994) Practice Note '*Reports by Auditors under Company Legislation in the UK*' provides three examples of unqualified auditors' reports and five examples of qualified reports. Thus, the standard wording in these reports, and the messages they attempt to convey, are well understood.

The technical statement *Accountants' Reports on Profit Forecasts* (ICAEW, 1978) includes one example only of an accountants' report – where there are no grounds for qualification. Situations where qualification is being considered are more difficult for practitioners. More guidance is therefore required from regulators on the wording to be used in qualified (or limited) accountants' reports.

Another area requiring attention from regulators is that highlighted in paragraph 4.5 – clarification is needed on the distinction between profit forecasts and projections; and on the implications for reporting accountants' arising from any distinctions made.

Finally, regulations do not currently provide guidance to reporting accountants on whether they should report on dividend forecasts. Many companies in the larger research project of 701 takeover bids in the period 1988 to 1992 made a dividend forecast. As shown in Example 25, only one of these dividend forecasts was reported on by reporting accountants. This practice of making dividend forecasts during bids without making a profit forecast appears to amount to a forecast 'by the back door'. Practitioners in this situation require more guidance on their responsibilities.

APPENDIX

Examples – listed alphabetically by reporting accountant

Reporting Accountant	Client	Takeover bid (Bidder-Target, Year)	Example
Arthur Andersen	Tomkins	Tomkins - Ranks Hovis McDougall, 1992	4
Arthur Young	Iceland Frozen Foods	Iceland Frozen Foods - Bejam, 1988	13
BDO Binder Hamlyn	ASIT Investment Trust	ASIT Investment Trust - Anglo Scandinavian Investment Trust, 1991	25
Brebner Allen & Trapp	Estates Property	Peachey Property - Estates Property, 1988	11
Clark Whitehill	Pearl Group	AMP – Pearl Group, 1989	20
Coopers & Lybrand Deloitte	Kingsgrange	Matahari 374 - Kingsgrange, 1991	12
Coopers & Lybrand Deloitte	Magnetic Materials	TT Group - Magnetic Materials, 1991	3
Ernst & Whinney	AGB Research	Pergamon - AGB Research, 1988	15
Ernst & Young	Ultramar	LASMO - Ultramar, 1991	9
Ernst & Young	United Scientific	Meggitt - United Scientific, 1989	17
Grant Thornton	Morland	Greene King - Morland, 1992	2
KPMG Peat Marwick McLintock	Caird Group	Severn Trent - Caird Group, 1990	22
Peat Marwick McLintock	Oilfield Inspection Services	Consortium - Oilfield Inspection Services, 1988	8
Peat Marwick McLintock	William Sommerville	James River - William Sommerville, 1989	6
Peat Marwick McLintock	Caradon	MB Group - Caradon, 1989	10
Peat Marwick McLintock	Chalford Communications	Chalford Communications - Crown TV, 1988	14
Peat Marwick McLintock	Molins	IEP – Molins, 1989	7
Price Waterhouse	Reed International	Elsevier – Reed International, 1992	1
Price Waterhouse	T. Cowie	T. Cowie - Henlys Group, 1992	6
Price Waterhouse	DRG	Pembridge Associates - DRG, 1989	16
Price Waterhouse	Highland Electronics	Arlen – Highland Electronics, 1990	18
Price Waterhouse	Lloyds Bank	Lloyds Bank - Abbey Life, 1988	19
Price Waterhouse	Peachey Property	Wereldhave - Peachey Property, 1988	21
Price Waterhouse	Hunting Gibson and Hunting Associated	Hunting Gibson - Hunting Associated, 1989	23
Price Waterhouse and Coopers & Lybrand Dijker Van Dien	Reed Elsevier	Elsevier - Reed, 1992	24

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