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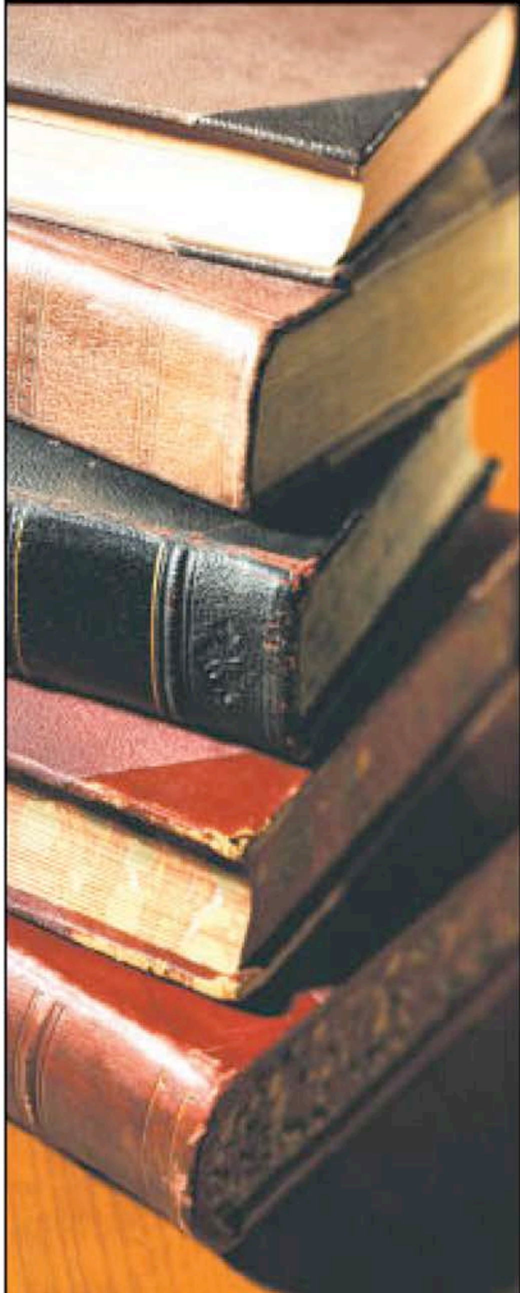

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Course #6845/QAS6845

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Prospective Financial Statements: Performance and Usage (Course #6845/QAS6845)

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Prospective Financial Statements: Performance and Usage

A. General

The use of prospective financial statements continues to grow as companies require their use to obtain financing and raise capital. More than ever, sophisticated investors and bankers want to know what “will” rather than what “did” happen. With the acceleration of financial information due to the rapid changes in technology, reliance on historical information by third parties is lessening as those same parties look for more "forward-looking" information. This trend is evidenced by a report issued several years ago by the FASB in which investors and other third parties were asked about what kind of financial information was lacking in the information presented to them. Overwhelmingly, the respondents stated that they wanted more "forward-looking" information; that is, information that would help them assess the direction of the company, its trends, products and competition. That same group of respondents confirmed that historical information had become outdated and less important, particularly by the time it was dispensed to them. The result is the focus on prospective financial information will continue to grow, requiring accountants in both public accounting and industry to understand the rules and how they can be used to benefit their clients and companies.

When are prospective financial statements useful?

For any businesses, prospective financial statements may be needed for a number of reasons including:

1. Obtain bank financing
2. Private or public placement
3. Internal management decisions

From experience, the author believes that most successful businesses take the budget process very seriously and use it as a compass to guide the company and for benchmarking. The outside accountant can play an important role in assisting financially unsophisticated companies in preparing a forecast or projection for either internal or third-party use. The preparation of a forecast or projection in conjunction with the preparation of historical financial statements and tax returns can be an attractive professional services package to offer to closely held businesses.

The fact that prospective financial statements have been prepared can also assist the accountant in performing his or her engagement on the historical financial statements whereby historical data can be compared with the budget for significant variances.

Another very useful purpose for prospective financial statements is to obtain or maintain bank financing. Many banks require that a company prepare an annual forecast or projection to submit to the bank along with the year-end historical financial statements.

How can an accountant use the forecast and projection rules to increase business?

The author observes that accountants in public practice do not use these projection rules enough to increase business with existing clients. It is apparent that the preparation of prospective financial statements is a natural extension of an accountant's reporting on historical financial statements. Many small businesses could use the accountant's assistance in preparing an annual forecast or projection for their own benefit and/or for the bank. Consider the following situations in which an accountant can sell the service of preparing a forecast or projection for an existing client:

a. A client wants a “budget” to evaluate a possible business acquisition.

b. A client wants an annual "budget" for submission to the client and third parties along with the historical financial statements and tax returns.

The author believes that an annual "budget" can be bundled with the preparation of historical financial statements and tax returns as a means to expand meaningful services for clients and differentiate the firm from its competitors.

Example: Mary CPA is bidding on a new client. The bid could include the following services:

1. Preparation of an annual compilation with no footnotes.
2. Preparation of a compiled budget (forecast or projection).
3. Preparation of annual tax returns including the individual tax return for the owner.

These services can be packaged together for one fixed price.

B. Authority for Prospective Financial Statements

The authority for preparing and reporting on prospective financial information is found in SSAE No. 10: *Attestation Standards: Revision and Recodification.* There are several statements of position that also give guidance and that are referenced throughout this course. The authoritative literature of SSAE No. 10 and other documents has been incorporated into the most comprehensive document available on the subject of prospective financial information: the AICPA Guide, *Prospective Financial Information* (the "Guide"). In the Guide, one finds a full set of specific presentation guidelines, and numerous examples and disclosures needed to prepare forecasted or projected financial statements.

Whenever an accountant submits to his or her client or others, reports on prospective financial statements that he or she has assembled or assisted in assembling, that are or reasonably might be expected to be used by another third party, the accountant should issue one of the following reports:

1. Compilation
2. Examination
3. Agreed-upon Procedures
4. Partial Presentation

Alternatively, where financial statements are expected to be used for internal use, the accountant may be engaged to perform the following services:

1. Plain Paper Engagement
2. Assembly

C. What are Prospective Financial Statements?

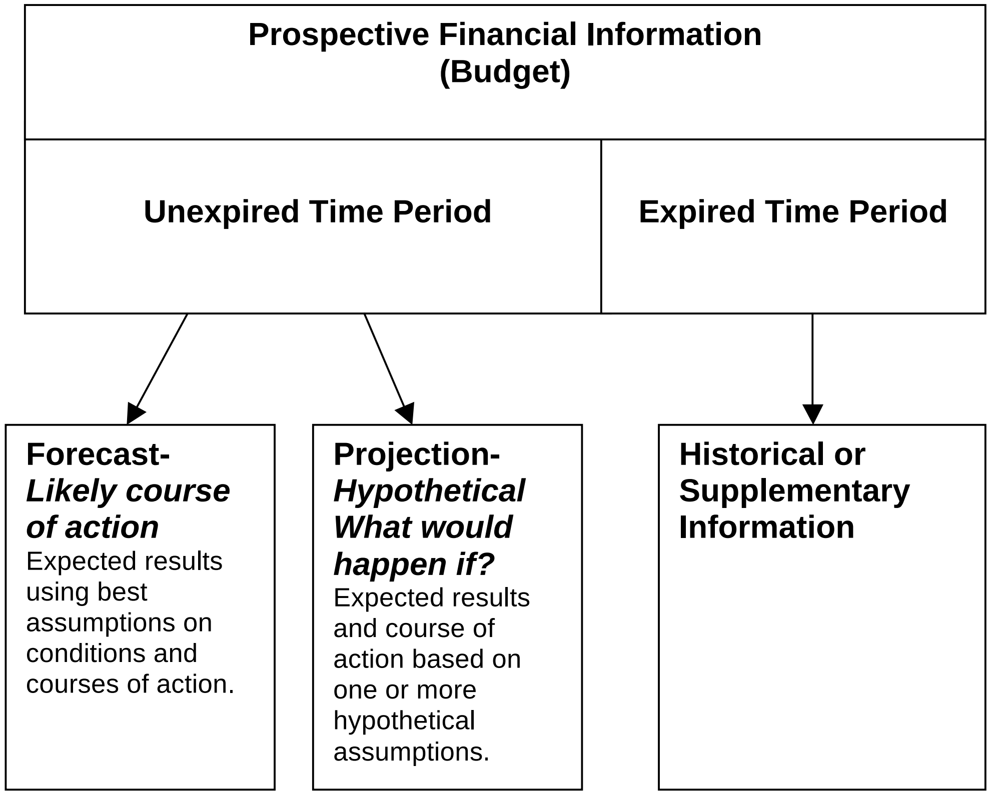
In practice, we typically use the term "*budget"* to identify prospective financial information. In the codification of prospective financial statements, the term "budget" is replaced with a more formal hierarchy consisting of either financial forecasts or financial projections including the related summaries of significant assumptions and accounting policies. Whether prospective financial information (a budget) is a forecast or projection depends on the circumstances that are discussed further below.

Understanding the difference between a financial forecast and a financial projection

In practice, accountants commonly confuse the application of a financial forecast versus a financial projection.

> A **financial forecast** consists of prospective financial statements that present an entity's expected financial position, result of operations, and cash flows. A forecast is based on the assumptions reflecting the conditions the responsible party *expects will exist and the course of action it expects to take.*
>
> A **financial projection** consists of prospective financial statements that present an entity's expected financial position, result of operations, and cash flows *given one or more hypothetical assumptions*. A projection presents one or more hypothetical courses of action for evaluation in response to the question *"What would happen if_____?"*

Another important point is that *prospective financial information must be for an unexpired period.* That is, once the period to which the prospective financial information has expired, it is no longer prospective. Rather, it becomes historical and usually is presented as supplementary information if presented comparatively with historical financial information. This point is discussed further in this segment of the course.



The best way to differentiate between a financial forecast and a projection is that a financial forecast takes into account the conditions that the responsible party expects will exist and the action he or she expects to take. Conversely, a projection reflects one or more courses of action that would be taken given one or more assumptions. Thus, a forecast reflects a more definitive course of action than a projection.

The following example illustrates the difference between a forecast and a projection.

Example 1: A company wants to expand its plant facility and needs to put together prospective financial statements in order to obtain financing for the expansion.

Conclusion: The company should prepare a projection based on the hypothetical assumption that it will get financing and will decide to build the plant. The projection is based on the questions: *What would happen if we obtained financing and built the plant? What would the financial statements look like?*

Notice that the company has not committed to this course of action.

Example 2: A company has obtained financing for a plant expansion and has committed to build the plant.

Conclusion: In this case, a forecast is appropriate. Because the financing has been obtained and the plant is scheduled for construction, there is no hypothetical assumption on which to build the prospective financial statements. Instead, a forecast should be prepared that presents the expected course of action based on receiving the financing and building the plant. Instead of asking what would happen if, the question asked in a forecast is: *What will the financial statements look like based on our planned course of action?*

A forecast or a projection can be expressed in specific monetary amounts as a single point of estimate or as a range.

When can financial statements be projected versus forecasted?

Sometimes, it is not clear as to whether a forecast or projection should be issued. Although it may be irrelevant to the third party, the decision to issue a forecast instead of a projection may be significant because a projection may not be issued for general use.

Factors that should be considered in deciding whether a forecast is a projection or vice versa include:

1. The intended use of the financial statements.
2. Whether the responsible party has a reasonable objective basis for the assumptions used.

If the financial statements are to be used only by management or certain third parties with whom the responsible party (presumably management) is negotiating directly (e.g., the bank), a projection may be acceptable because the statements do not have to be distributed for general use.

A more important factor is whether the responsible party has a reasonable objective basis for the assumptions used. If an objective basis can support the assumption used, a forecast can be issued. If, on the other hand, there is not an objective basis to support the assumption, then there is a hypothetical assumption requiring a projection, not a forecast.

Example: Let's assume a company seeks bank financing for a plant expansion. The prospective financial statements will be used to obtain the financing from a bank with whom the company is negotiating directly for the loan. Must a forecast or a projection be performed?

Conclusion: The first consideration is the use of the prospective financial statements. Because the financial statements will be used either by the company or the bank with whom the company is negotiating, the statements are categorized for limited use, meaning a projection or forecast may be issued.

The second consideration is whether the responsible party (in this case, management) has an objective basis for the assumptions used. In this scenario, one assumption is that financing will be obtained to build the plant. However, is that assumption based on objective evidence? That is, is there evidence to suggest that the assumption that financing will be obtained, so that the plant can be built, likely to come to fruition? The answer is that it depends on the factors involved in the case. If the company has just started the process of seeking financing and is not close to getting a bank commitment, it is likely that the assumption is hypothetical and not based on objective evidence. The result is that a projection, not a forecast, must be issued.

Change the facts: The company has actively been negotiating with the bank and simultaneously getting permits, etc. for the construction. Because the company has a strong financing history with this bank, it appears likely that the company will easily obtain the necessary construction permits.

Is this assumption that the company will obtain financing to construct its plant based on objective evidence (forecast) or a hypothetical assumption requiring a projection?

Conclusion: The evidence appears more objective than subjective supporting the fact that the event will occur. The result is a financial forecast, rather than a projection, can be issued.

Legal Liability – Forecast versus a Projection

Another consideration in determining whether to report on a forecast or projection is the level of risk associated with each. A forecast represents the expected course of action while a projection is hypothetical. This difference can be significant if a third party decides to sue the accountant because that party is damaged due to an overly optimistic forecast or projection. The author believes that there is less risk in reporting on a projection rather than a forecast because a projection is hypothetical and does not purport to represent the likely course of action.

D. Financial Statements Excluded from the Definition of Prospective Financial Statements

Prospective financial statements <u>exclude</u>:

1. Financial statements for periods that have completely expired.
2. Pro forma financial statements.
3. Partial presentation financial statements.
4. Prospective financial statements used solely in connection with litigation support services.

Note: Prospective financial statements may cover a period that has partially (but not fully) expired.

If the prospective financial statements are not expected to be used by a third party, the provisions of SSAE No. 10 do not apply unless the accountant has been engaged to examine, compile or apply agreed-upon procedures to the prospective financial statements. The accountant may rely on the written or oral representation of the responsible party in deciding whether the prospective financial statements are expected to be used by a third party.

E. Use of Prospective Financial Statements

Prospective financial statements may be categorized either for general use, limited use, or internal use.

General use refers to use by persons with whom the responsible party is not negotiating directly such as in the case of an offering statement of an entity's debt or equity interests.

Only forecasted financial statements may be distributed for general use, while a financial projection is for limited use only.

Limited use refers to use of prospective financial statements by:

- The responsible party alone.
- The responsible party and third parties with whom the responsible party is negotiating such as use in negotiating a bank loan, submission to a regulatory agency, or use solely within the entity.

For example, if a company is negotiating for a bank loan, limited use parties would include the company and any banks with whom the company is ***negotiating directly*** for the loan. Other third parties would not be part of the "limited use" group. The term negotiating directly means that the third party user has the ability to ask questions of, and negotiate the terms or structure of, a transaction directly with the responsible party.[1]

Internal use: An accountant may issue an assembly or partial presentation of financial statements restricted for use by the responsible party. Such presentations are not covered by SSAE No. 10.

When must prospective financial statements be restricted from general use?

The classification of prospective financial statement use as either "general" or "limited" use is not dependent on the number of uses. Rather, the use is considered limited if each of the users negotiates directly with the responsible party. Parties that are not negotiating with the responsible party are considered general users.

Prospective financial statements to be used by even one passive user who is not negotiating directly with the responsible party means the financial statements are considered general use. Conversely, where the users of the financial statements are all negotiating directly with the responsible party, the statements are considered limited use.

Prospective financial statements should be restricted from general use (e.g., limited to use) in either of the following situations:

[1] Section 23.03 of Part 4, AICPA Guide to Prospective Financial Information.

1. When a financial projection is issued.
2. When the responsible party does not have a reasonable objective basis for one or more assumptions.

Projected financial statements should be treated as limited use. Because a financial projection is not appropriate for general use, an accountant should not consent to the use of his or her name in conjunction with a financial projection that he or she believes will be distributed to those who will not be negotiating directly with the responsible party unless the projection is used to supplement a forecast.

The following is an example of the language that is required to included in the financial projection report to limit use:

> *The accompanying projection and this report are intended solely for the information and use of XYZ Company and No Loan Bank and Trust, and is not intended to be and should not be used by anyone other than these specified parties.*

Is the concept materiality considered in the preparation of prospective financial statements?

Yes. The concept of materiality does apply to prospective financial statements. However, because prospective information is far less precise than historical information, the scope of materiality should be judged in light of the expected range of reasonableness of the information. Users should not expect prospective information to be as precise as historical information.

F. Format of Prospective Financial Statements

Generally, prospective financial statements include a full set of financial statements (balance sheet, statement of income, cash flows, etc.) for the prospective period. Many accountants prefer to prepare a full set of prospective financial statements to offer a more polished presentation to the third party (e.g., bank, etc.) and to allow for an easier comparison with the historical financial statements at the end of the year.

The statements are prepared in accordance with GAAP or an other comprehensive basis of accounting (OCBOA) such as the income tax or cash basis.

SSAE No. 10 does not require that a forecast or projection be presented on a full set of financial statements. Instead, the presentation can be in the form of an abbreviated version of prospective financial statements, offering limited financial statement elements.

Specifically, SSAE No. 10 states that an accountant may report on prospective financial statements as long as the following elements are presented as a minimum. The SSAE refers to this list as the *Minimum Presentation Guidelines*. For purposes of the discussion in this course, the author will refer to the Minimum Presentation Guidelines as the *"Minimum Elements for Prospective Financial Statements."*

Minimum Elements for Prospective Financial Statements:

1. Sales or gross revenues
2. Gross profit or cost of sales
3. Unusual or infrequently occurring items
4. Provision for income taxes
5. Discontinued operations or extraordinary items
6. Income from continuing operations
7. Net income
8. Basic and diluted earnings per share
9. Significant changes in financial position
10. Introductory paragraph that includes a description of what the responsible party intends the prospective financial statements to present, a statement that the assumptions are based on the responsible party's judgment at the time the prospective information was prepared, and a caveat that the prospective results may not be achieved.
11. Summary of significant assumptions
12. Summary of significant accounting policies.

The elements required for prospective financial statements are far less extensive than those required for historical financial statements. The following chart illustrates the differences between the two.

Comparison of Presentations of Historical Versus Prospective Financial Statements	
Historical Financial Statements	**Prospective Financial Statements**
Requires basic financial statements: Balance sheet, statement of income, statement of cash flows and changes in equity.	Full set of basic financial statements may be presented. Minimum elements are required.
Not applicable to historical financial statements.	An introduction paragraph that has a description of what the responsible party intends the prospective financial statements to present, a statement that the assumptions are based on the responsible party's judgment at the time the prospective information was prepared, and a caveat that the prospective results may not be achieved.
Statement of cash flows is required.	Significant changes in financial position are required.
Summary of significant accounting policies required.	Summary of significant accounting policies required.
Summary of significant assumptions is not applicable.	Summary of significant assumptions required. A projection must present the hypothetical assumption on which the projection is based.
Footnotes are required.	Footnotes not required.

The accountant must choose between two formats for the prospective financial statements:

Option 1: Present a full set of financial statements, or

Option 2: Provide a limited presentation consisting of the minimum elements.

From experience, the author generally recommends that the accountant select a full set of financial statements in a format that mirrors the presentation of historical financial statements. By doing so, at the end of the year, the actual results can be compared with the prospective financial statements. Further, an abbreviated version of financial statements that results from including only the minimum elements may not be meaningful to the client or third parties.

What if one or more of the minimum items are missing?

A presentation that omits one or more of the above items 1 through 9 is considered a partial presentation, which is generally not appropriate for general use. A presentation that contains all of items 1-9, but omits any of items 10-12 above, is considered a complete presentation requiring a report modification. Partial presentations are discussed in more detail further on in this course.

There is an exception whereby management may elect to omit the summary of significant accounting policies in a compilation, similar to where an accountant may elect to omit substantially all disclosures in a compilation of historical financial statements. If the summary of significant accounting policies (Item 12) is omitted, the compilation report must include a separate paragraph noting this fact.

Are footnotes required in prospective financial statements?

No. Although a full set of footnotes can be included in the prospective financial statements, they are not required and usually not necessary. Instead, the presentation must include both the summary of significant assumptions and the summary of significant accounting policies used in the preparation of the prospective financial statements. Other notes that are customarily required for historical financial statements may be added, although not required.

Prospective Financial Statements That Include a Range

When the prospective financial statements contain a range, the standard report should include a separate paragraph that states that the responsible party has elected to portray the expected results of one or more assumptions as a range. The following illustrates the additional paragraph that would be included in a prospective financial statement report, which in this case relates to a forecast:

> *As described in the summary of significant assumptions, management of XYZ Company has elected to portray forecasted revenue at the amounts of $xxx and $yyy, which is predicated upon occupancy rates of XX percent and YY percent of available apartments, rather than as a single point estimate. Accordingly, the accompanying forecast presents forecasted financial position, results of operations, and cash flows at such occupancy rates. However, there is no assurance that the actual results will fall within the range of occupancy rates presented.*

Basis of Accounting and Accounting Principles Used for Prospective Financial Statements

Usually, prospective financial statements are presented in accordance with GAAP using the same basis of accounting (e.g., accrual basis). However, statements may be prepared on an other comprehensive basis of accounting (OCBOA). The basis used depends on the ultimate use of the financial statements. For example, if prospective financial statements are prepared on a real estate partnership, an income tax basis may be a more appropriate format for preparing the prospective financial statements. Moreover, different accounting principles may be used in the prospective financial statements as compared with the historical financial statements. For example, LIFO may be used for the forecast while FIFO is used on the historical financial statements.

Should the prospective financial statements be prepared on the same basis of accounting as the historical financial statements using the same accounting principles?

There is no requirement that the prospective financial statements be prepared on the same basis as the historical financial statements nor use the same accounting principles.

The AICPA Guide*,* *Prospective Financial Information* (the "Guide") does give some assistance:

> "Financial forecasts usually should be prepared on a basis consistent with the accounting principles expected to be used in the historical financial statements covering the prospective period. Although ordinarily a financial projection should use the accounting principles expected to be used in the historical statements, sometimes the special purpose of the presentation requires that it be prepared based on other accounting principles. In such cases, *the use of different accounting principles should be disclosed*……."
>
> "Ideally, prospective financial statements and historical financial statements should be available to users on the same basis of accounting. Occasionally, a different comprehensive basis of accounting is used for a financial forecast than that to be used for the historical financial statements for the prospective period. In such situations, the use of a different basis should be disclosed, and *differences in results of operations and changes in financial position or cash flows resulting from the use of a different basis usually would be reconciled in the financial forecast*."

The Guide suggests that it is advisable to use the same basis of accounting and accounting principles that are used in the preparation of the historical financial statements for the prospective period. However, if a different basis of accounting or accounting principles is used, there are two actions that should be taken:

1. Different accounting principles used: There should be a disclosure of the fact that different accounting principles are used with the effect on results of operations and financial position.

2. Different basis of accounting used: There should be a reconciliation between the results of operations, changes in financial position or cash flows from using the two different methods.

The following examples illustrate the application of the above two requirements.

Facts: The LIFO method of accounting for inventories is used for a financial forecast while FIFO is used in the historical financial statements.

Disclosure of use of a different accounting principle

The forecast (projection) assumes that inventory will be valued on the last-in, first-out method, whereas the company has historically used the first-in, first-out method in preparation of its historical financial statements. If the latter method were used in this forecast (projection), inventory and income before income taxes would be increased by $XX, provision for income taxes would be increased and other working capital decreased by $XX, and net income and shareholders' equity would be increased by $XX.

Note: This disclosure would be presented in the attached summary of significant accounting policies.

Facts: The forecast is prepared on the income tax basis of accounting while GAAP is used for the historical financial statements.

Reconciliation of Income Tax Basis of Accounting Used for the Financial Forecast to the Accrual Basis of Accounting Used for Preparation of Historical Financial Statements.

The following is a reconciliation between the income tax basis of accounting used to prepare the financial forecast and generally accepted accounting principles used to prepare the historical financial statements for 20X1 and 20X2.

	20X1	20X2
Net income – forecasted financial statements prepared on the income tax basis of accounting	$4,500	$5,500
Add (deduct):		
Expenses deducted for historical financial statement purposes, not deducted on the income tax basis financial statements:		
Meals and entertainment	(1,000)	(1,000)
Key-man life insurance	(2,000)	(1,800)
Income recorded for historical financial statement purposes, not included in income tax basis financial statements:		
Non-taxable interest income	4,000	5,000
Net income – historical financial statements prepared based on generally accepted accounting principles	$5,500	$7,500

G. Compilation of Prospective Financial Statements

1. General

Perhaps the most common type of engagement on prospective financial statements is a compilation. Generally, there is significant risk with an accountant reporting on prospective financial statements due to the uncertainty of the outcome of information. A compilation report minimizes the accountant's exposure as compared with an examination. (From experience, the author notes that most banks will accept a compilation report on prospective financial statements.) Therefore, there is generally no need for an accountant to upgrade the engagement to an examination or to use an agreed-upon procedures engagement.

As we saw earlier in this course, the Attestation Standards include the review, examination and agreed-upon procedures engagement, but excludes a compilation engagement. The exception is that the Attestation Standards permit a compilation engagement to be performed on prospective financial statements. So, why is a compilation of prospective financial information offered as an option under the Attestation Standards?

The answer extends to the origin of the prospective financial statements rules and the advent of the SSAEs. The Auditing Standards Board continues to avoid permitting a review of prospective financial information. The reason is because of the concern that offering negative assurance on prospective financial information may be confusing to the public and result in a potential misunderstanding about the intent of the report by third parties. Because a review was not offered as an option, a compilation was included to offer an alternative to an examination or agreed-upon procedures.

2. Standards to follow in conducting a compilation engagement

The compilation of prospective financial statements under SSAE No. 10 essentially follows the requirements of SSARS No. 19. That is, minimal responsibility is taken for the adequacy of the financial information. The accountant essentially reads the information and places the prospective information into a financial statement format in accordance with the SSAE No. 10 requirements.

The following standards apply to a compilation of prospective financial statements and to the resulting report:

1. The compilation should be performed by persons having adequate technical training and proficiency to compile prospective financial statements.
2. Due professional care should be exercised in the performance of the engagement and issuance of the report.
3. The work should be adequately planned and supervised.
4. Applicable compilation procedures should be performed.
5. The report should conform to the applicable reporting requirements for compiled prospective financial statements.

In order to perform a compilation of prospective financial statements, the following steps must be followed:

1. Establish an understanding with the client regarding the services to be performed.
2. Inquire about the accounting principles used in the preparation of the prospective financial statements.

   a. Compare the accounting principles used to those used in the preparation of previous historical financial statements.

   b. Inquire as to whether such principles are the same as those expected to be used in the historical financial statements covering the prospective period.

   c. For entities to be formed or entities formed that have not started operations, compare specialized industry accounting principles used to those typically used in the industry and those expected to be used when the entity starts operations.

3. Ask how the responsible party identifies the key factors and develops its assumptions.

4. Obtain a list of the responsible party's assumptions used in the prospective financial statements.

   a. Consider whether there are any obvious omissions in light of the key factors upon which the prospective results of the entity appear to depend.

   b. Consider whether there appear to be any obvious internal inconsistencies in the assumptions.

   c. Perform or test the mathematical accuracy of the computations that translate the assumptions into prospective financial statements.

5. Read the prospective financial statements with their summaries of significant assumption and accounting policies and consider whether:

   a. The financial statements appear to be presented in conformity with AICPA presentation guidelines (within the AICPA Auditing and Accounting Guide, *Prospective Financial Information*) and not obviously inappropriate.

   b. The financial statements appear to be appropriate in relation to the accountant's knowledge of the entity and its industry and for the following:

      <u>Forecast</u>: the expected conditions and course of action in the prospective period.

      <u>Projection</u>: the purpose of the presentation.

6. If a significant part of the prospective period has expired, the accountant should inquire about the results of operations and changes in financial position, and consider their effect in relation to the prospective financial statements.

   If historical financial statements have been prepared for the expired period, the accountant should read the statements and consider those results in relation to the prospective financial statements.

7. Confirm his or her understanding of the statements, including assumptions, by obtaining a written representation letter from the responsible party, signed by the responsible party at the highest level of authority.

8. Issue a compilation report.

The working papers for a compilation of prospective financial statements should usually include information that the work was adequately performed and supervised, and that the required compilation procedures were performed.

A compilation engagement is not intended to provide assurance on the prospective financial statements or the assumptions underlying such statements. A compilation does not provide assurance that the accountant will become aware of significant matters that might be disclosed by more extensive procedures performed in, for example, an examination engagement.

Further, after applying the procedures, the accountant should consider whether representations or other information he or she has received appear to be obviously inappropriate, incomplete, or otherwise misleading, and if so, the accountant should attempt to obtain additional or revised information. If the accountant does not receive such information, he or she should usually withdraw from the compilation engagement. However, the omission of disclosures, other than those relating to significant assumptions, would not require the accountant to withdraw.

3. Engagement Letter- Compilation of Prospective Financial Statements

SSAE No. 10 requires that the accountant establish an understanding with the client regarding the services to be performed, preferably in writing. The understanding should include:

- The objectives of the engagement.
- The client's responsibilities.
- The accountant's responsibilities.
- The limitations of the engagement.

As with other engagements, the accountant should document the understanding, preferably with an engagement letter. Because of the risk that the ultimate results may differ from those forecasted and projected, it is critical that the accountant obtain an engagement letter in a prospective financial statements engagement.

The AICPA Guide provides the following sample engagement letter.

Engagement Letter – Compilation of Financial Forecast

Mr. John Jones
President
Jones Manufacturing
Jonesville, GA

Dear Mr. Jones:

This letter sets forth our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will compile, in accordance with attestation standards established by the American Institute of Certified Public Accountants, from information management provides, the forecasted balance sheet and the related forecasted statements of income, retained earnings, cash flows, and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 20XX, and for the year then ending. A compilation is limited to presenting, in the form of a financial forecast, information that is the representation of management. We will not examine the financial forecast, and therefore, will not express any form of assurance on the achievability of the forecast or the reasonableness of the underlying assumptions.

A compilation of a financial forecast involves assembling the forecast based on management's assumptions and performing certain other procedures with respect to the forecast without evaluating the support for, or expressing an opinion or any other form of assurance on, the assumptions underlying it. If for any reason we are unable to complete our compilation of your financial forecast, we will not issue a report on it as a result of this engagement.

A financial forecast presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and cash flows for the forecast period. It is based on management's assumptions, reflecting conditions it expects to exist and the course of action it expects to take during the forecast period.

Management is responsible for representations about its plans and expectations and for disclosure of significant information that might affect the ultimate realization of the forecasted results.

There will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. Our report will contain a statement to that effect.

We have no responsibility to update our report for events and circumstances occurring after the date of such report.

At the conclusion of the engagement, management agrees to supply us with a representation letter that, among other things, will confirm management's responsibility for the underlying assumptions and the appropriateness of the financial forecast and its presentation.

In order for us to complete this engagement, management must provide assumptions that are appropriate for the forecast. If the assumptions provided are inappropriate and have not been revised to our satisfaction, we will be unable to complete the engagement, and, accordingly, will not issue a report on the forecast.

If management intends to reproduce and publish the forecast and our report thereon, they must be reproduced in their entirety, and both the first and subsequent, corrected drafts of the document containing the forecast and any accompanying material must be submitted to us for approval.

Our fees for this engagement will be significant and hopefully outrageous.

James J. Fox & Company, CPA

This letter sets forth our understanding of the terms and conditions of our agreement:

____

John Jones, President

Engagement Letter – Compilation of Financial Projection

Mr. John Jones
President
Jones Manufacturing
Jonesville, GA

Dear Mr. Jones:

This letter sets forth our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will compile, in accordance with attestation standards established by the American Institute of Certified Public Accountants, from information management provides, the projected balance sheet and the related forecasted statements of income, retained earnings, cash flows, and summaries of significant assumptions and accounting policies of XYZ Company as of December 31, 20XX, and for the year then ending. A compilation is limited to presenting, in the form of a financial projection, information that is the representation of management. We will not examine the projected financial statements and therefore, will not express any form of assurance on the achievability of the forecast or the reasonableness of the underlying assumptions.

A compilation of a financial projection involves assembling the projection based on management's assumptions and performing certain other procedures with respect to the projection without evaluating the support for, or expressing an opinion or any other form of assurance on, the assumptions underlying it. If for any reason we are unable to complete our compilation of your financial forecast, we will not issue a report on it as a result of this engagement.

The financial projection presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and cash flows for the projection period assuming [insert the hypothetical assumptions]. It is based on management's assumptions, reflecting conditions it expects would exist and courses of action it expects would be taken during the projection period assuming [describe hypothetical assumptions].

Management is responsible for representations about its plans and expectations and for disclosure of significant information that might affect the ultimate realization of the projected results.

Even if [describe hypothetical assumptions] were to occur, there will usually be differences between projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. Our report will contain a statement to that effect.

We have no responsibility to update our report for events and circumstances occurring after the date of such report.

At the conclusion of the engagement, management agrees to supply us with a representation letter that, among other things, will confirm management's responsibility for the underlying assumptions and the appropriateness of the financial projection and its presentation.

In order for us to complete this engagement, management must provide assumptions that are appropriate for the projection. If the assumptions provided are inappropriate and have not been revised to our satisfaction, we will be unable to complete the engagement, and, accordingly, will not issue a report on the projection.

We understand that the projection and our report thereon will be used only for [state the intended limited use]. If management intends to reproduce and publish the projection and our report thereon, they must be reproduced in their entirety, and both the first and subsequent, corrected drafts of the document containing the projection and any accompanying material must be submitted to us for approval.

Our fees for this engagement will be significant and hopefully outrageous.

James J. Fox & Company, CPA

This letter sets forth our understanding of the terms and conditions of our agreement:

____

John Jones, President

4. Representation Letter – Compilation of Prospective Financial Statements

When it comes to a compilation under SSARS No. 19, an accountant is required to have an understanding with the client in writing of the services to be performed. That written understanding does not have to be in the form of an engagement letter even though a signed engagement letter is the most logical form of written communication. Therefore, SSARS No. 19 permits other forms of written communication, such as a written communication from the accountant to the client that the client does not sign.

Unlike the SSARS No. 19 requirements in connection with a compilation engagement on historical financial statements, <u>*SSAE No. 10 requires that an accountant obtain a representation letter for a compilation of prospective financial statements*</u>. This requirement is also required for an examination which should not surprise the reader.

The reason for the required representation letter in a compilation is because of the significant risk associated with the engagement and the extensive reliance placed on management's assumptions used to prepare the forecast or projection. The entire basis of the financial statements lies in the assumptions that do not have a parallel with historical financial statements.

SSAE No. 10 states that the accountant should confirm his or her understanding of the statements (including the assumptions) by obtaining written representations from the responsible party, presumably management. The accountant should obtain representations in which the responsible party indicates its responsibility for the assumptions.

The representation letter should also be signed by the responsible party having the highest authority who the accountant believes is responsible for and knowledgeable about matters covered by the representations.

For forecasts and projections, the representations should include:

1. The responsible party's assertion that the forecast or projection presents to the best of its knowledge and belief, the expected financial position, results of operations, and cash flows for the forecast period, and, that the forecast reflects the responsible party's judgment, based on present circumstances, of the expected conditions and its expected course of action.

   Note: If there is a projection, the representation should be modified to reflect the hypothetical assumptions and the expected course of action given the occurrence of the hypothetical events.

2. A statement that the forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants.

3. A statement that the assumptions on which the forecast is based are reasonable.

4. If there is a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

For a projection, the representations should additionally:

5. Identify the hypothetical assumptions and describe the limitations on the usefulness of the presentation.

6. State that the assumptions are appropriate.

7. Indicate if the hypothetical assumptions are improbable.

Representation Letter – Compilation of Financial Forecast

James J. Fox & Company, CPA
87 Terrace Hall Avenue
Burlington, MA 01803

In connection with your compilation of the forecasted balance sheet and the related forecasted statements of income, retained earnings, and cash flows and summaries of significant assumptions and accounting policies of XYZ Corporation as of December 31, 20XX and for the year then ending, we make the following representations.

1. The financial forecast presents our assumptions and, to the best of our knowledge and belief, the Company's expected financial position, results of operations, and cash flows for the period in conformity with generally accepted accounting principles expected to be used by the Company during the forecast period, which are consistent with the principles XYZ Corporation uses in preparing its historical financial statements.
2. The financial forecast reflects our judgment based on present circumstances of the expected conditions and our expected course of action.
3. The financial forecast is presented in conformity with the guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants.
4. We believe the assumptions underlying the forecast are reasonable and appropriate.
5. We have made available to you all significant information that we believe is relevant to the forecast.
6. To the best of our knowledge and belief, the documents and records supporting the assumptions are appropriate.
7. [If the forecast is presented as a range, insert the following additional representation]:

We reasonably expect, to the best of our knowledge and belief, that the actual [describe items presented as a range] achieved will be within a range shown; however, there can be no assurances that it will. The range shown was not selected in a biased or misleading manner.

8. If the date of the signed representations is later than the date of the preparation of the forecast, the following representation would be added:

We are not aware of any material changes in the information or circumstances from [date], the date of the forecast, to the present.

John Smith, President
Smith Manufacturing Co.
Date:

Representation Letter – Compilation of Financial Projection

James J. Fox & Company, CPA
87 Terrace Hall Avenue
Burlington, MA 01803

In connection with your compilation of the projected balance sheet and the related projected statements of income, retained earnings, and cash flows and summaries of significant assumptions assuming [describe hypothetical assumptions] and accounting policies of XYZ Corporation as of December 31, 20XX and for the year then ending, we make the following representations.

1. The financial projection presents our assumptions and, to the best of our knowledge and belief, the Company's expected financial position, results of operations, and cash flows for the projection period assuming [describe the hypothetical assumptions].

2. The accounting principles used in the financial projection are in conformity with generally accepted accounting principles expected to be used by the Company during the projection period, which are consistent with the principles XYZ Corporation uses in preparing its historical financial statements.

3. The financial projection reflects our judgment based on present circumstances of the expected conditions and our expected course of action assuming [describe hypothetical assumptions].

4. The financial projection is presented in conformity with the guidelines for presentation of a financial projection established by the American Institute of Certified Public Accountants.

5. We believe the assumptions underlying the projection are appropriate and reasonable assuming [describe hypothetical assumptions].

6. We have made available to you all significant information that we believe is relevant to the financial projection.

7. To the best of our knowledge and belief, the documents and records supporting the assumptions are appropriate.

8. We intend to use this projection only for [describe intended limited use].

9. [If the projection is presented as a range, insert the following additional representation]:

We reasonably expect, to the best of our knowledge and belief, that the actual [describe items presented as a range] achieved will be within a range shown assuming [describe hypothetical assumptions]; however, there can be no assurances that it will. The range shown was not selected in a biased or misleading manner.

John Smith, President
Smith Manufacturing Co.
Date

5. Compilation Report on Prospective Financial Statements

Although the compilation report for prospective financial statements is similar to the compilation report for historical financial statements under SSARS No. 19, *Compilation and Review Engagements,* there are differences in the language. SSARS No. 19 changed the compilation report for historical financial statements. To date, similar changes have not been made to SSAE No. 10 for a compilation report on prospective financial statements. Thus, at the date that this course is being published, the SSAE No. 10 compilation report is similar to the old compilation report on historical financial statements previously found in SSARS No. 1.

The following are sample reports on compiled prospective financial statements.

Example 1: Compilation Report on Financial Forecast

Sample Report: Standard Compilation Report on a Financial Forecast

Board of Directors[2]
XYZ Company

We have compiled the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending, in accordance with Attestation Standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of a forecast information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

James J. Fox & Company, CPA
March 1, 20XX

Observation: The compilation report on a financial forecast or projection has old language that is similar to the compilation report that existed prior to the issuance of SSARS No. 19. When SSARS No. 19 was issued effective in 2010, the compilation report related to historical financial statements was modified, while the compilation report related to financial forecasts and projections under SSAE No. 10 was not changed. Notice, for example, that the compilation report on a financial forecast in Example 1 *does not have a title* while the standard compilation report found in SSARS No. 19 does have a title.

[2] The SSAE No. 10 compilation report on financial forecasts or projections, does not require that there be an addressee, even though a traditional compilation report under SSARS No. 19 requires an addressee. The author recommends that an addressee be included in the report even though not required.

Example 1: Compilation Report on Financial Forecast- With a Range

If the financial forecast contains a range, the standard compilation report should include a separate paragraph as follows:

Board of Directors
XYZ Company

We have compiled the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending, in accordance with Attestation Standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of a forecast information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

As described in the summary of significant assumptions, management of XYZ Company has elected to portray forecasted [describe the financial element(s) for which the expected results of one or more assumptions fall within a range, and identify the assumptions expected to fall with a range] rather than as a single-point estimate. Accordingly, the accompanying forecast presents forecasted financial position, results of operations, and cash flows [describe one or more assumptions expected to fall within a range]. However, there is no assurance that the actual results will fall within the range [describe one or more of the assumptions expected to fall within a range] presented.

James J. Fox & Company, CPA
March 1, 20XX

Example 2: Compilation Report on Financial Projection

When issuing a compilation report on a financial projection, the report must include several additional elements as follows:

a. A statement describing the special purpose for which the projection was prepared.

b. A separate paragraph that restricts the use of the report because it is intended to be used solely by the specified parties.

A sample compilation report on a financial projection looks like this for which additional items beyond those required in a financial forecast are noted in ***bold italic.***

Sample Report: Standard Compilation Report on a Financial Projection

Board of Directors
XYZ Company

We have compiled the accompanying projected balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending, in accordance with Attestation Standards established by the American Institute of Certified Public Accountants. ***The accompanying projection was prepared for the purpose of negotiating a loan to expand XYZ Company's plant investment.***

A compilation is limited to presenting in the form of a projection, information that is the representation of management and does not include evaluation of the support for the assumptions underlying the projection. We have not examined the projection and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, ***even if the loan is granted and the plant investment is expanded***, there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

The accompanying projection and this report are intended solely for the information and use of XYZ Company and No Loan Bank and Trust, and is not intended to be and should not be used by anyone other than these specified parties.

James J. Fox & Company
March 1, 20XX

6. Variations from the Standard Compilation Report on Prospective Financial Statements.

There are four instances in which an accountant would modify the standard compilation report in connection with prospective financial statements:

a. If the accountant is not independent – SSAE No. 17.
b. Emphasis of a matter.
c. There is a deficiency or omission.
d. The summary of significant accounting policies is omitted.

a. The accountant is not independent – SSAE No. 17

If the accountant is not independent with respect to the reporting entity, the accountant should include the following sentence after the last paragraph in a compilation report:

We are not independent with respect to XYZ Company.

SSARS No. 19, *Compilation and Review Engagements,* permits an accountant, in a compilation engagement, to disclose the reason(s) for lack of independence. Prior to 2010, that same option was not available for a compilation engagement on prospective financial statements under the SSAEs.

In December 2010, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Attestation Engagements (SSAE) No. 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence Is Impaired.*

SSAE No. 17 brings the rules for independence for a compilation of prospective financial statements in line with a compilation of historical statements *by permitting, but not requiring, an accountant to disclose the reason(s) for lack of independence*.

SSAE No. 17 amends AT section 301*, Financial Forecasts and Projections*, to insert the following new language:

> "A practitioner may compile prospective financial statements for an entity with respect to which he or she is not independent. In such circumstances, the practitioner's report should be modified to indicate his or her lack of independence in a separate paragraph of the practitioner's report. An example of such a disclosure would be:
>
> > We are not independent with respect to XYZ Company."
>
> ***The practitioner is not precluded from disclosing a description about the reason(s) that his or her independence is impaired***. The following are examples of descriptions the practitioner may use:
>
> > We are not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because a member of the engagement team *had a direct financial interest in XYZ Company*.
> >
> > We are not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because an immediate family member of one of the members of the engagement team *was employed by XYZ Company*.
> >
> > We are not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because we *performed certain bookkeeping and payroll tax services* (the accountant may include a specific description of those services) that impaired our independence.

Note: If an accountant elects to disclose a description about the reasons his or her independence is impaired, the accountant should ensure that *all reasons* are included in the description.

SSAE No. 17 became effective for compilations of prospective financial statements for periods *ending on or after December 15, 2010*.

b. Emphasis of a matter

Like historical financial statements, an accountant may wish to expand the report to emphasize a matter. Such information should be presented in a separate paragraph of the compilation report. The accountant should be careful that by emphasizing a matter, there is not an impression that he or she is expressing assurance or expanding the degree of responsibility with respect to the information. For example, the accountant should not include statements in his or her compilation report about the mathematical accuracy of the statements or their conformity with presentation guidelines.

c. Deficiency or omission

The accountant should modify his or her compilation report where the prospective financial statements include a deficiency or omission and the accountant does not believe the deficiency or omission was undertaken with the intent of being misleading to the financial statement users.

d. Management elects to omit the summary of significant accounting policies

SSARS No. 19 allows an accountant to omit substantially all GAAP (or OCBOA) disclosures and the statement of cash flows in compiled historical financial statements. A similar option is permitted with respect to the compilation of prospective statements where an accountant may elect to omit the summary of significant accounting policies. The paragraph is similar to the one used in SSARS No. 19 when an accountant elects to omit substantially all disclosures required by GAAP. If this election is made, a separate paragraph must be included in the compilation report as follows:

> *Management has elected <u>to omit the summary of significant accounting policies</u> required by the guidelines for presentation of a forecast (or projection) established by the American Institute of Certified Public Accountants. If the omitted disclosures were included in the forecast (or projection), they might influence the user's conclusions about the company's financial position, results of operations, and cash flows for the forecast (or projection) period. Accordingly, this forecast (or projection) is not designed for those who are not informed about such matters.*

May the summary of significant assumptions also be omitted?

No. With respect to a compilation report on prospective financial statements, management may elect to omit only the summary of significant accounting policies, and not the summary of significant assumptions. In all cases, the summary of significant assumptions must be presented and, any omission, would result in a report modification.

Note: With respect to an examination of prospective financial statements, the option to omit the summary of significant accounting policies is not available and, if omitted, results in the issuance of either a qualified or adverse examination report.

If the prospective financial statements are presented on an other comprehensive basis of accounting (OCBOA), such as the income tax basis, and there is no disclosure of the basis of accounting used, the basis should be disclosed in the compilation report.

Example 1: Standard Compilation Report on Financial Forecast

The following is an example of a compilation report and the related financial forecasted financial statements.

Facts: Michael's Manufacturing Co. is required to submit a two-year forecast to the bank for its bank financing. The accountant suggests that a compilation report be issued. The forecast reflects a full set of financial statements.

The report and financial statements are presented as follows:

Board of Directors
Michael's Manufacturing Co.

We have compiled the accompanying forecasted balance sheet, statements of income and retained earnings, and cash flows of Michael's Manufacturing Co. as of December 31, 20X1 and 20X2, and for the years then ending, ***in accordance with attestation standards established by the American Institute of Certified Public Accountants.***

A compilation is limited to presenting in the form of a forecast, information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

James J. Fox & Company, CPA
March 1, 20X1

Michael's Manufacturing Co.
Forecasted Balance Sheets
December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
ASSETS		
Current assets:		
Cash and equivalents	$3,000	$4,000
Accounts receivable, net of allowance	60,000	65,000
Inventories	40,000	42,000
Prepaid expenses and other current assets	4,000	5,000
Total current assets	107,000	116,000
Property and equipment:		
Cost	100,000	150,000
Less accumulated depreciation	17,000	25,000
Total property and equipment	83,000	125,000
Other assets:	5,000	6,000
	$195,000	$247,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$24,000	$28,000
Accrued expenses and taxes	5,000	6,000
Notes payable- bank	4,000	7,000
Current portion of long-term debt	1,000	2,000
Total current liabilities	34,000	43,000
Long-term debt, net of current portion:	30,000	40,000
Deferred income taxes	2,000	3,000
Stockholders' equity:		
Common stock	1,000	1,000
Retained earnings	128,000	160,000
Total stockholders' equity	129,000	161,000
	$195,000	$247,000

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

Michael's Manufacturing Co.
Forecasted Statements of Income and Retained Earnings
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
Net sales	$500,000	$600,000
Cost of sales	340,000	440,000
Gross profit on sales	160,000	160,000
Selling, general and administrative expenses	90,000	100,000
Net operating income	70,000	60,000
Other income, net	10,000	8,000
Income before income taxes	80,000	68,000
Income taxes	32,000	36,000
Net income	48,000	32,000
Retained earnings:		
Beginning of year	80,000	128,000
End of year	$128,000	$160,000

See accompanying Summary of Significant Forecast Assumptions
and Accounting Policies.

Michael's Manufacturing Co.
Forecasted Statements of Cash Flows
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
Cash flows from operating activities:		
Net income	$48,000	$32,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	6,000	8,000
Deferred income taxes	(2,000)	1,000
Change in:		
Accounts receivable	(3,000)	(5,000)
Inventories	(4,000)	(2,000)
Prepaid expenses and other assets	1,000	(2,000)
Accounts payable	7,000	4,000
Accrued expenses and taxes	(1,000)	1,000
Net cash provided by operating activities	52,000	37,000
Cash flows used for investing activities:		
Purchases of property and equipment	(56,000)	(50,000)
Net cash used for investing activities	(56,000)	(50,000)
Cash flows from financing activities:		
Proceeds from bank loans	1,000	3,000
Proceeds from long-term borrowings	6,500	13,000
Repayment of long-term debt	(1,500)	(2,000)
Net cash from financing activities	6,000	14,000
Net increase in cash and cash equivalents	2,000	1,000
Cash and cash equivalents:		
Beginning of year	1,000	3,000
End of year	$3,000	$4,000

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

Michael's Manufacturing Co.
Summary of Significant Forecast Assumptions
and Accounting Policies
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

1. General Nature of Financial Forecasts

The financial forecast presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and cash flows for the forecast period. Accordingly, the forecast reflects management's judgment as of March 1, 20X1, the date of this forecast, of the expected conditions and its expected course of action. The assumptions disclosed herein are those that management believes are significant to the forecast. There will usually be differences between forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

2. Nature of Business

The Company is a manufacturer of widgets used in the leather manufacturing business with sales made to leather manufacturers throughout the United States. The forecast assumes that the company will continue to sell its products to leather manufacturers throughout the United States with the same product mix and geographic diversity as it has historically maintained.

3. Summary of Significant Accounting Policies

a. The Company uses the accrual basis whereby revenue is recognized as earned and expenses when incurred.
b. The company's policy is to expense advertising as incurred.
c. Depreciation is recorded on a straight-line basis over the assets estimated useful lives.

Manufacturing equipment	5 years
Office fixtures	7 years
Technology equipment and software	3 years

d. Inventories are valued at cost using the first-in, first-out basis, not in excess of market value.

4. Summary of Significant Forecast Assumptions

The forecast reflects the following management assumptions:

a. <u>Sales</u>:

The Company's market share is forecasted to increase from 6 percent of the United States market in 20X0 to 8 percent and 9 percent, respectively, in 20X1 and 20X2. As a result of a forecasted increase in market share, sales are forecasted to increase 25 percent from 20X0 to 20X1, and 20 percent from 20X1 to 20X2.

The credit terms of trade receivables are forecasted to remain steady at 45 days for 20X1 and 20X2.

b. Cost of sales:

Materials: Materials used by the Company are expected to be readily available in both 20X1 and 20X2. The unit costs of prime materials purchases are forecasted to increase by 2 percent per year based on information from trade associations.

Labor: Approximately 90 percent of the Company's manufacturing labor is represented under a collective bargaining agreement with the Leather Manufacturers' Union. The union contract was negotiated in 20X0 for a three-year period through April 20X3. Labor costs for 20X1 and 20X2 are forecasted based on the terms of the union contract.

c. Inventories:

Inventories are forecasted to maintain at levels to accommodate forecasted sales volume. The forecast reflects inventory levels to maintain approximately a 90-day supply of inventory and a turnover of 4 for each forecast period.

Consistent with the company's practice, the timing of the payment of purchases assumes that all purchase discounts will be taken. Accounts payable are forecasted at 15 days outstanding for each forecast period.

d. Property and equipment:

Forecasted additions to property and equipment total $56,000 in 20X1 and $50,000 in 20X2, comprised principally of new computer-based manufacturing equipment.

e. Debt:

The forecasts reflect the following debt transactions:

1. The Company plans to maintain its $10,000 line of credit with No Loan Bank and Trust. The Company will be required to borrow additional amounts on the line totaling $1,000 in 20X1 and $3,000 in 20X2, resulting in loan balances of $4,000 and $7,000 at December 31, 20X1 and 20X2, respectively. Interest is forecasted at the prime rate of 8% throughout the forecast periods.

2. Term loans: The company plans to borrow a portion of the funds required to purchase additional property and equipment, with the remainder of the purchase price being funded through cash. Additional term loans are forecasted to be $6,500 in 20X1 and $13,000 in 20X2 with a five-year amortization at a fixed interest rate of 8% per annum. Principal payments under all term loans are forecasted at $1,500 in 20X1 and $2,000 in 20X2.

f. Income taxes:

The provision for income taxes is computed using statutory rates in effect for 20X1 and 20X2, which are not expected to change. The forecast reflects an effective federal and state income tax rate of 40% per year. Deferred income taxes are computed based on temporary differences between the basis of assets and liabilities for tax and financial statement purposes.

g. Selling, general and administrative expenses:

Expenses are forecasted on an individual-expense-basis using the following significant assumptions:

1. Salaries will increase by 3 percent per year. Two additional sales positions and three general office positions will be filled in early 20X2, with no additional positions required in 20X1.
2. Occupancy costs including rent, depreciation, insurance and utilities are forecasted to increase by 5 percent per year. The company's lease on its principal manufacturing and office facility requires a lease payment increase of 5 percent in 20X1 and 35 percent in 20X2.
3. Transportation costs: Because of continued increases in transportation costs including national trucking, the Company forecasts increases in transportation costs of 10 percent for each forecast period.
4. The forecast reflects a 3 percent increase in all other selling, general and administrative expenses in each forecast period.

-end of report-

Observations- Example 1:

Example 1 illustrates the most common application of a financial forecast; that is, a compilation with a full set of financial statements, along with the accompanying attachments. In looking at the accompanying pages labeled *Summary of Significant Forecast Assumptions and Accounting Policies*, there are several items that must be present.

1. *Note 1,* General Nature of Financial Forecast, presents the required language that is included in the Minimum Elements. That is, there must be a note that includes a description of what the responsible party (the client) intends the financial statements to present, the fact that the statements are based on the responsible party's judgment, and a caveat that the results may not be achieved. Note 1 makes these assertions.

2. *Note 2*, Nature of Business, arguably is not required. The nature of business (operations) note is required by ASC 275, *Risks and* Uncertainties (formerly SOP 94-6), for historical statements, but there is no similar requirement for prospective financial statements. Further, disclosing the nature of business does not come under the heading of a significant accounting policy because it is not a policy at all. The author suggests that the inclusion of a nature of business note is important as a lead in to the remainder of the policies and assumptions, and that an accountant may wish to consider including it as part of the forecast or projection.

3. *Note 3,* includes the summary of significant accounting policies which is required as a Minimum Element under the prospective financial statements rules. As noted earlier, with respect to a compilation, management may elect to omit this section, as noted in Example 2 below. The author has intentionally segregated the policies from the assumptions section noted in Note 4. Some accountants co-mingle these sections into footnotes based on the subject matter. For example, it may be more meaningful to combine the depreciation policy in Note 3(c) with the forecast assumptions on Property and Equipment in Note 4(d).

4. *Note 4,* includes the Summary of Significant Assumptions which is required as a Minimum Element for prospective financial statements.

Example 2: Compilation- Election to Omit Summary of Significant Accounting Policies.

The following is an example of a compilation report and the related forecasted financial statements where the company elects to omit the summary of significant accounting policies.

The report must include a separate paragraph noting the election to omit the summary of significant accounting policies.

Board of Directors
Michael's Manufacturing Co.

We have compiled the accompanying forecasted balance sheet, statements of income and retained earnings, and cash flows of Michael's Manufacturing Co. as of December 31, 20X1 and 20X2, and for the years then ending, in accordance with Attestation Standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of a forecast, information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Management has elected to omit the summary of significant accounting policies required by the guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants. If the omitted disclosures were included in the forecast, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows for the forecast period. Accordingly, this forecast is not designed for those who are not informed about such matters.

James J. Fox & Company, CPA
March 1, 20X1

Michael's Manufacturing Co.
Forecasted Balance Sheets
December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
ASSETS		
Current assets:		
Cash and equivalents	$3,000	$4,000
Accounts receivable, net of allowance	60,000	65,000
Inventories	40,000	42,000
Prepaid expenses and other current assets	4,000	5,000
Total current assets	107,000	116,000
Property and equipment:		
Cost	100,000	150,000
Less accumulated depreciation	17,000	25,000
Total property and equipment	83,000	125,000
Other assets:	5,000	6,000
	$195,000	$247,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$24,000	$28,000
Accrued expenses and taxes	5,000	6,000
Notes payable- bank	4,000	7,000
Current portion of long-term debt	1,000	2,000
Total current liabilities	34,000	43,000
Long-term debt, net of current portion:	30,000	40,000
Deferred income taxes	2,000	3,000
Stockholders' equity:		
Common stock	1,000	1,000
Retained earnings	128,000	160,000
Total stockholders' equity	129,000	161,000
	$195,000	$247,000

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

Michael's Manufacturing Co.
Forecasted Statements of Income and Retained Earnings
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
Net sales	$500,000	$600,000
Cost of sales	340,000	440,000
Gross profit on sales	160,000	160,000
Selling, general and administrative expenses	90,000	100,000
Net operating income	70,000	60,000
Other income, net	10,000	8,000
Income before income taxes	80,000	68,000
Income taxes	32,000	36,000
Net income	48,000	32,000
Retained earnings:		
Beginning of year	80,000	128,000
End of year	$128,000	$160,000

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

Michael's Manufacturing Co.
Forecasted Statements of Cash Flows
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
Cash flows from operating activities:		
Net income	$48,000	$32,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	6,000	8,000
Deferred income taxes	(2,000)	1,000
Change in:		
Accounts receivable	(3,000)	(5,000)
Inventories	(4,000)	(2,000)
Prepaid expenses and other assets	1,000	(2,000)
Accounts payable	7,000	4,000
Accrued expenses and taxes	(1,000)	1,000
Net cash provided by operating activities	52,000	37,000
Cash flows used for investing activities:		
Purchases of property and equipment	(56,000)	(50,000)
Net cash used for investing activities	(56,000)	(50,000)
Cash flows from financing activities:		
Proceeds from bank loans	1,000	3,000
Proceeds from long-term borrowings	6,500	13,000
Repayment of long-term debt	(1,500)	(2,000)
Net cash from financing activities	6,000	14,000
Net increase in cash and cash equivalents	2,000	1,000
Cash and cash equivalents:		
Beginning of year	1,000	3,000
End of year	$3,000	$4,000

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

Michael's Manufacturing Co.
Summary of Significant Forecast Assumptions
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

1. General Nature of Financial Forecasts

The financial forecast presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and cash flows for the forecast period. Accordingly, the forecast reflects management's judgment as of March 1, 20X1, the date of this forecast, of the expected conditions and its expected course of action. The assumptions disclosed herein are those that management believes are significant to the forecast. There will usually be differences between forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

2. Nature of Business

[This section is eliminated. The author presents the caption only to illustrate that it is removed altogether.]

3. Summary of Significant Accounting Policies

[This section is eliminated. The author presents the caption only to illustrate that it is removed altogether.]

4. Summary of Significant Forecast Assumptions

The forecast reflects the following management assumptions.

a. Sales:

The Company's market share is forecasted to increase from 6 percent of the United States market in 20X0 to 8 percent and 9 percent, respectively, in 20X1 and 20X2. As a result of a forecasted increase in market share, sales are forecasted to increase 25 percent from 20X0 to 20X1, and 20 percent from 20X1 to 20X2.

The credit terms of trade receivables are forecasted to remain steady at 45 days for 20X1 and 20X2.

b. Cost of sales:

Materials: Materials used by the Company are expected to be readily available in both 20X1 and 20X2. The unit costs of prime material purchases are forecasted to increase by 2 percent per year based on information from trade associations.

Labor: Approximately 90 percent of the Company's manufacturing labor is represented under a collective bargaining agreement with the Leather Manufacturers' Union. The union contract was negotiated in 20X0 for a three-year period through April 20X3. Labor costs for 20X1 and 20X2 are forecasted based on the terms of the union contract.

c. Inventories:

Inventories are forecasted to be maintained at levels to accommodate forecasted sales volume. The forecast reflects inventory levels to maintain approximately a 90-day supply of inventory and a turnover of 4 for each forecast period.

Consistent with the company's practice, the timing of the payment of purchases assumes that all purchase discounts will be taken. Accounts payable are forecasted at 15 days outstanding for each forecast period.

d. Property and equipment:

Forecasted additions to property and equipment total $56,000 in 20X1 and $50,000 in 20X2, comprised principally of new computer-based manufacturing equipment.

e. Debt:

The forecasts reflect the following debt transactions:

1. The Company plans to maintain its $10,000 line of credit with No Loan Bank and Trust. The Company will be required to borrow additional amounts on the line totaling $1,000 in 20X1 and $3,000 in 20X2, resulting in loan balances of $4,000 and $7,000 at December 31, 20X1 and 20X2, respectively. Interest is forecasted at the prime rate of 8% throughout the forecast periods.

2. Term loans: The company plans to borrow a portion of the funds required to purchase additional property and equipment, with the remainder of the purchase price being funded through cash. Additional term loans are forecasted to be $6,500 in 20X1 and $13,000 in 20X2 with a five-year amortization at a fixed interest rate of 8% per annum. Principal payments under all terms loans are forecasted at $1,500 in 20X1 and $2,000 in 20X2.

f. Income taxes:

The provision for income taxes is computed using statutory rates in effect for 20X1 and 20X2, which are not expected to change. The forecast reflects an effective federal and state income tax rate of 40% per year. Deferred income taxes are computed based on temporary differences between the basis of assets and liabilities for tax and financial statement purposes.

g. Selling, general and administrative expenses:

Expenses are forecasted on an individual expense basis using the following significant assumptions:

1. Salaries will increase by 3 percent per year. Two additional sales positions and three general office positions will be filled in early 20X2, with no additional positions required in 20X1.

2. Occupancy costs including rent, depreciation, insurance and utilities are forecasted to increase by 5 percent per year. The company's lease on its principal manufacturing and office facility requires a lease payment increase of 5 percent in 20X1 and 35 percent in 20X2.

3. Transportation costs: Because of continued increases in transportation costs including national trucking, the Company forecasts increases in transportation costs of 10 percent for each forecast period.

4. The forecast reflects a 3 percent increase in all other selling, general and administrative expenses in each forecast period.

-end of report-

Observations- Example 2

Example 2 illustrates the option management can use to omit the summary of significant accounting policies. A few observations about this format.

1. The Example 2 report is modified to include a separate paragraph noting the omission as highlighted in bold italic.

2. Because the accounting policies are omitted, the title of the attachment is changed to: *Summary of Significant Forecast Assumptions*.

3. Note 2, *Nature of Business*, disclosure has been eliminated. Because this note is not required in the first place, the author believes that in an instance where the accounting policies are omitted, the nature of business disclosure should also be removed. The result is that only the significant forecast assumptions remain.

4. Note 3, *Summary of Significant Accounting Policies*, is omitted in accordance with the election to omit this section as noted in the report.

5. Note 4, *Summary of Significant Forecast Assumptions*, is the only segment remaining. The special election only allows the omission of the Summary of Significant Accounting Policies, not the Summary of Significant Forecast Assumptions.

Example 3: Compilation Report- Summarized Financial Forecast Using the Minimum Elements

SSAE No. 10 requires that a list of minimum elements be presented in order for the presentation to qualify as a forecast or projection. The following is an example of a compilation report and the related financial forecasted financial statements.

Facts: Same facts as Example 1 except that the Company wishes to present the forecast in a summarized format which includes the Minimum Elements required by SSAE No.10.

Board of Directors
Michael's Manufacturing Co.

We have compiled the accompanying ***Summarized Financial Forecast*** of Michael's Manufacturing Co. as of December 31, 20X1 and 20X2, and for the years then ending, in accordance with Attestation Standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of a forecast, information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

James J. Fox & Company

March 1, 20X1

Michael's Manufacturing Co.
Summarized Financial Forecast
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
Net sales	$500,000	$600,000
Gross profit on sales	160,000	160,000
Unusual or infrequently occurring items	None	None
Income taxes	32,000	36,000
Discontinued operations or extraordinary items	None	None
Income from continuing operations	48,000	32,000
Net income	48,000	32,000
Basic and diluted earnings per share:		
Basic	$.20	$.24
Diluted	.12	.16
Significant changes in financial position:		
Cash provided by operating activities	$52,000	$37,000
Purchases of property and equipment	(56,000)	(50,000)
Proceeds from bank loans and long-term borrowings	7,500	16,000
Increase in cash and cash equivalents	2,000	1,000

See accompanying Summary of Significant Forecast Assumptions
and Accounting Policies.

Michael's Manufacturing Co.
Summary of Significant Forecast Assumptions
and Accounting Policies
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

1. General Nature of Financial Forecasts

The financial forecast presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and cash flows for the forecast period. Accordingly, the forecast reflects management's judgment as of March 1, 20X1, the date of this forecast, of the expected conditions and its expected course of action. The assumptions disclosed herein are those that management believes are significant to the forecast. There will usually be differences between forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

2. Nature of Business

The Company is a manufacturer of widgets used in the leather manufacturing business with sales made to leather manufacturers throughout the United States. The forecast assumes that the company will continue to sell its products to leather manufacturers throughout the United States with the same product mix and geographic diversity as it has historically maintained.

3. Summary of Significant Accounting Policies

a. The Company uses the accrual basis whereby revenue is recognized as earned and expenses when incurred.
b. The company's policy is to expense advertising as incurred.
c. Depreciation is recorded on a straight-line basis over the assets estimated useful lives.

Manufacturing equipment	5 years
Office fixtures	7 years
Technology equipment and software	3 years

d. Inventories are valued at cost using the first-in, first-out basis, not in excess of market value.

4. Summary of Significant Forecast Assumptions

The forecast reflects the following management assumptions.

a. <u>Sales</u>:

The Company's market share is forecasted to increase from 6 percent of the United States market in 20X0 to 8 percent and 9 percent, respectively, in 20X1 and 20X2. As a result of a forecasted increase in market share, sales are forecasted to increase 25 percent from 20X0 to 20X1, and 20 percent from 20X1 to 20X2.

The credit terms of trade receivables are forecasted to remain steady at 45 days for 20X1 and 20X2.

b. Cost of sales:

Materials: Materials used by the Company are expected to be readily available in both 20X1 and 20X2. The unit costs of prime material purchases are forecasted to increase by 2 percent per year based on information from trade associations.

Labor: Approximately 90 percent of the Company's manufacturing labor is represented under a collective bargaining agreement with the Leather Manufacturers' Union. The union contract was negotiated in 20X0 for a three-year period through April 20X3. Labor costs for 20X1 and 20X2 are forecasted based on the terms of the union contract.

c. Inventories:

Inventories are forecasted to be maintained at levels to accommodate forecasted sales volume. The forecast reflects inventory levels to maintain approximately a 90-day supply of inventory and a turnover of 4 for each forecast period.

Consistent with the company's practice, the timing of the payment of purchases assumes that all purchase discounts will be taken. Accounts payable are forecasted at 15 days outstanding for each forecast period.

d. Property and equipment:

Forecasted additions to property and equipment total $56,000 in 20X1 and $50,000 in 20X2, comprised principally of new computer-based manufacturing equipment

e. Debt:

The forecasts reflect the following debt transactions:

1. The Company plans to maintain its $10,000 line of credit with No Loan Bank and Trust. The Company will be required to borrow additional amounts on the line totaling $1,000 in 20X1 and $3,000 in 20X2, resulting in loan balances of $4,000 and $7,000 at December 31, 20X1 and 20X2, respectively. Interest is forecasted at the prime rate of 8% throughout the forecast periods.

2. Term loans: The company plans to borrow a portion of the funds required to purchase additional property and equipment, with the remainder of the purchase price being funded through cash. Additional term loans are forecasted to be $6,500 in 20X1 and $13,000 in 20X2 with a five-year amortization at a fixed interest rate of 8% per annum. Principal payments under all term loans are forecasted at $1,500 in 20X1 and $2,000 in 20X2.

f. Income taxes:

The provision for income taxes is computed using statutory rates in effect for 20X1 and 20X2, which are not expected to change. The forecast reflects an effective federal and state income tax rate of 40% per year. Deferred income taxes are computed based on temporary differences between the basis of assets and liabilities for tax and financial statement purposes.

g. Selling, general and administrative expenses:

Expenses are forecasted on an individual expense basis using the following significant assumptions:

1. Salaries will increase by 3 percent per year. Two additional sales positions and three general office positions will be filled in early 20X2, with no additional positions required in 20X1.

2. Occupancy costs including rent, depreciation, insurance and utilities are forecasted to increase by 5 percent per year. The company's lease on its principal manufacturing and office facility requires a lease payment increase of 5 percent in 20X1 and 35 percent in 20X2.

3. Transportation costs: Because of continued increases in transportation costs including national trucking, the Company forecasts increases in transportation costs of 10 percent for each forecast period.

4. The forecast reflects a 3 percent increase in all other selling, general and administrative expenses in each forecast period.

-end of report-

Observations- Example 3

Example 3 illustrates an abbreviated version of a financial forecast that is available. Under this format, only the Minimum Elements required under the prospective financial statements rules are included in the *Summarized Financial Forecast*. The standard financial statements (balance sheet, income statement, changes in equity, and cash flows statement) are not presented. Also, in the Summarized Financial Forecast, the author has shown several items that do not exist, such as the unusual or infrequently occurring items. If an item on the Minimum Elements list does not exist, there is no requirement to present that item. The author has presented several items that do not exist with a "none" note next to them, to illustrate the complete list of items included on the Minimum Element list.

Example 3 also includes the summary of significant forecast assumptions and accounting policies. When this abbreviated version is presented, the incentive must be to perform the forecast in the least amount of time. Thus, it is likely that management would elect to omit the summary of significant accounting policies, as well. (See Example 4 which illustrates this option.)

The author believes that the Summarized Financial Forecast (or projection) is generally not meaningful to a third-party user, and should be used only in limited cases where the third party is aware of the limitations of its use. For example, the summarized version does not include a balance sheet which may be important to a third party such as a bank. Moreover, the abbreviated income statement information may be lacking to the third party.

Example 4: Compilation with Summarized Financial Forecast and Election to Omit the Summary of Significant Accounting Policies

If an accountant is looking to issue the easiest financial forecast, he or she can report on a summarized financial forecast that reflects the list of minimum elements, coupled with the election to omit the summary of significant accounting policies. The result is the simplest financial forecast that is available under the prospective financial statement rules.

The following is a sample of the results using this format.

Board of Directors
Michael's Manufacturing Co.

We have compiled ***the accompanying Summarized Financial Forecast*** of Michael's Manufacturing Co. as of December 31, 20X1 and 20X2, and for the years then ending, in accordance with Attestation Standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of a forecast, information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Management has elected to omit the summary of significant accounting policies required by the guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants. If the omitted disclosures were included in the forecast, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows for the forecast period. Accordingly, this forecast is not designed for those who are not informed about such matters.

James J. Fox & Company, CPA
March 1, 20X1

Michael's Manufacturing Co.
Summarized Financial Forecast
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
Net sales	$500,000	$600,000
Gross profit on sales	160,000	160,000
Unusual or infrequently occurring items (1)	None	None
Income taxes	32,000	36,000
Discontinued operations/extraordinary items (1)	None	None
Income from continuing operations	48,000	32,000
Net income	48,000	32,000
Basic and diluted earnings per share:		
Basic	$.20	$.24
Diluted	.12	.16
Significant changes in financial position:		
Cash provided by operating activities	$52,000	$37,000
Purchases of property and equipment	(56,000)	(50,000)
Proceeds from bank loans and long-term borrowings	7,500	16,000
Increase in cash and cash equivalents	2,000	1,000

See accompanying Summary of Significant Forecast Assumptions
and Accounting Policies.

(1) If the company does not have certain Minimum Elements, those elements can be eliminated from the presentation. In the above example, the author included those items with reference to "none" to illustrate that these items are included in Minimum Element listing. Because there are no amounts with these items, they would not be shown at all in the actual presentation.

Michael's Manufacturing Co.
Summary of Significant Forecast Assumptions
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

1. General Nature of Financial Forecasts

The financial forecast presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and cash flows for the forecast period. Accordingly, the forecast reflects management's judgment as of March 1, 20X1, the date of this forecast, of the expected conditions and its expected course of action. The assumptions disclosed herein are those that management believes are significant to the forecast. There will usually be differences between forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

2. Nature of Business

[This section is eliminated. The author presents the caption only to illustrate that it is removed altogether.]

3. Summary of Significant Accounting Policies

[This section is eliminated. The author presents the caption only to illustrate that it is removed altogether.]

4. Summary of Significant Forecast Assumptions

The forecast reflects the following management assumptions:

a. Sales:

The Company's market share is forecasted to increase from 6 percent of the United States market in 20X0 to 8 percent and 9 percent, respectively, in 20X1 and 20X2. As a result of a forecasted increase in market share, sales are forecasted to increase 25 percent from 20X0 to 20X1, and 20 percent from 20X1 to 20X2.

The credit terms of trade receivables are forecasted to remain steady at 45 days for 20X1 and 20X2.

b. Cost of sales:

Materials: Materials used by the Company are expected to be readily available in both 20X1 and 20X2. The unit costs of prime material purchases are forecasted to increase by 2 percent per year based on information from trade associations.

Labor: Approximately 90 percent of the Company's manufacturing labor is represented under a collective bargaining agreement with the Leather Manufacturers' Union. The union contract was negotiated in 20X0 for a three-year period through April 20X3. Labor costs for 20X1 and 20X2 are forecasted based on the terms of the union contract.

c. Inventories:

Inventories are forecasted to be maintained at levels to accommodate forecasted sales volume. The forecast reflects inventory levels to maintain approximately a 90-day supply of inventory and a turnover of 4 for each forecast period.

Consistent with the company's practice, the timing of the payment of purchases assumes that all purchase discounts will be taken. Accounts payable are forecasted at 15 days outstanding for each forecast period.

d. Property and equipment:

Forecasted additions to property and equipment total $56,000 in 20X1 and $50,000 in 20X2, comprised principally of new computer-based manufacturing equipment

e. Debt:

The forecasts reflect the following debt transactions:

1. The Company plans to maintain its $10,000 line of credit with No Loan Bank and Trust. The Company will be required to borrow additional amounts on the line totaling $1,000 in 20X1 and $3,000 in 20X2, resulting in loan balances of $4,000 and $7,000 at December 31, 20X1 and 20X2, respectively. Interest is forecasted at the prime rate of 8% throughout the forecast periods.

2. Term loans: The company plans to borrow a portion of the funds required to purchase additional property and equipment, with the remainder of the purchase price being funded through cash. Additional term loans are forecasted to be $6,500 in 20X1 and $13,000 in 20X2 with a five-year amortization at a fixed interest rate of 8% per annum. Principal payments under all terms loans are forecasted at $1,500 in 20X1 and $2,000 in 20X2.

f. Income taxes:

The provision for income taxes is computed using statutory rates in effect for 20X1 and 20X2, which are not expected to change. The forecast reflects an effective federal and state income tax rate of 40% per year. Deferred income taxes are computed based on temporary differences between the basis of assets and liabilities for tax and financial statement purposes.

g. Selling, general and administrative expenses:

Expenses are forecasted on an individual expense basis using the following significant assumptions:

1. Salaries will increase by 3 percent per year. Two additional sales positions and three general office positions will be filled in early 20X2, with no additional positions required in 20X1.

2. Occupancy costs including rent, depreciation, insurance and utilities are forecasted to increase by 5 percent per year. The company's lease on its principal manufacturing and office facility requires a lease payment increase of 5 percent in 20X1 and 35 percent in 20X2.

3. Transportation costs: Because of continued increases in transportation costs including national trucking, the Company forecasts increases in transportation costs of 10 percent for each forecast period.

4. The forecast reflects a 3 percent increase in all other selling, general and administrative expenses in each forecast period.

-end of report-

Observation- Example 4: The above Example 4 illustrates the simplest financial forecast format available; that is, a Summarized Financial Forecast coupled with only the Summary of Significant Forecast Assumptions. The author believes this application has limited third-party use because of the lack of information about the company's financial position and results of operations.

Example 5: Compilation of a Financial Projection

Because a projection represents a hypothetical scenario versus the expected course of action with a forecast, a projection is used less often than a forecast. Typically, third parties such as banks want to know what the most likely course of action will look like, which is a forecast.

The following is an example of a compilation report and the related Financial Projection.

Facts: Michael's Manufacturing Co. seeks financing for a potential plant expansion. In order to consider the application for additional financing, the bank wants the accountant to prepare a "what if" scenario for two years; 20X1 and 20X2 assuming the company obtains financing and builds the plant. Because the prospective financial statements are based on a hypothetical scenario (e.g., building a plant), the accountant should issue projection rather than a forecast. The projection reflects a full set of financial statements.

The report and financial statements look like this:

Board of Directors
Michael's Manufacturing Co.

We have compiled the accompanying projected balance sheet, statements of income, retained earnings, and cash flows of Michael's Manufacturing Co. as of December 31, 20XX, and for the year then ending, in accordance with Attestation Standards established by the American Institute of Certified Public Accountants.

The accompanying projection was prepared for the purpose of negotiating a loan to expand the Company's manufacturing plant.

A compilation is limited to presenting in the form of a projection, information that is the representation of management and does not include evaluation of the support for the assumptions underlying the projection. We have not examined the projection and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore*, **even if the loan is granted and the plant investment is expanded***, there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

The accompanying projection and this report are intended solely for the information and use of Michael's Manufacturing and No Loan Bank and Trust, and is not intended to be and should not be used by anyone other than these specified parties.

James J. Fox & Company, CPA
March 1, 20XX

Michael's Manufacturing Co.
Projected Balance Sheets
December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
ASSETS		
Current assets:		
Cash and equivalents	$2,000	$3,000
Accounts receivable, net of allowance	60,000	65,000
Inventories	40,000	42,000
Prepaid expenses and other current assets	4,000	5,000
Total current assets	106,000	115,000
Property and equipment:		
Cost	105,000	155,000
Less accumulated depreciation	17,000	25,000
Total property and equipment	88,000	130,000
Other assets:	5,000	6,000
	$199,000	$251,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$24,000	$28,000
Accrued expenses and taxes	5,000	6,000
Notes payable- bank	4,000	7,000
Current portion of long-term debt	1,000	2,000
Total current liabilities	34,000	43,000
Long-term debt, net of current portion:	34,000	44,000
Deferred income taxes	2,000	3,000
Stockholders' equity:		
Common stock	1,000	1,000
Retained earnings	128,000	160,000
Total stockholders' equity	129,000	161,000
	$199,000	$251,000

See accompanying Summary of Significant Projection Assumptions
and Accounting Policies.

Michael's Manufacturing Co.
Projected Statement of Income and Retained Earnings
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
Net sales	$500,000	$600,000
Cost of sales	340,000	440,000
Gross profit on sales	160,000	160,000
Selling, general and administrative expenses	90,000	100,000
Net operating income	70,000	60,000
Other income, net	10,000	8,000
Income before income taxes	80,000	68,000
Income taxes	32,000	36,000
Net income	48,000	32,000
Retained earnings:		
Beginning of year	80,000	128,000
End of year	$128,000	$160,000

See accompanying Summary of Significant Forecast Assumptions
and Accounting Policies.

Michael's Manufacturing Co.
Projected Statements of Cash Flows
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

	20X1	20X2
Cash flows from operating activities:		
Net income	$48,000	$32,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	6,000	8,000
Deferred income taxes	(2,000)	1,000
Change in:		
Accounts receivable	(3,000)	(5,000)
Inventories	(4,000)	(2,000)
Prepaid expenses and other assets	1,000	(2,000)
Accounts payable	7,000	4,000
Accrued expenses and taxes	(1,000)	1,000
Net cash provided by operating activities	52,000	37,000
Cash flows used for investing activities:		
Costs for plant expansion	(5,000)	0
Purchases of property and equipment	(56,000)	(50,000)
Net cash used for investing activities	(61,000)	(50,000)
Cash flows from financing activities:		
Proceeds from bank loans	1,000	3,000
Proceeds from loan for plant expansion	4,000	0
Proceeds from long-term borrowings	6,500	13,000
Repayment of long-term debt	(1,500)	(2,000)
Net cash from financing activities	10,000	14,000
Net increase in cash and cash equivalents	1,000	1,000
Cash and cash equivalents:		
Beginning of year	1,000	2,000
End of year	$2,000	$3,000

See accompanying Summary of Significant Projection Assumptions and Accounting Policies.

Michael's Manufacturing Co.
Summary of Significant Projection Assumptions
and Accounting Policies
For the Years Ended December 31, 20X1 and 20X2
(See Accountant's Compilation Report)

1. General Nature of Financial Forecasts

The financial projections assume that the Company obtains additional financing to construct an additional manufacturing plant. This projection presents, to the best of management's knowledge and belief, the Company's expected financial position, results of operations, and cash flows for the projection ***period if a plant were constructed to increase production capacity by approximately 25%.*** Accordingly, the projection reflects management's judgment as of March 1, 20X1, the date of this projection, of the ***expected conditions and its expected course of action if such a plant were constructed.***

The presentation is designed to provide information for potential bank financing of the construction of the additional plant and cannot be considered to be a presentation of expected future results. Accordingly, the projection may not be useful for other purposes.

The assumptions disclosed herein are those that management believes are significant to the projection; however*, **management has not decided that it will construct such a plant. Even if the plant were constructed,*** there will usually be differences between projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

2. Nature of Business

The Company is a manufacturer of widgets used in the leather manufacturing business with sales made to leather manufacturers throughout the United States. The projection assumes that the company will continue to sell its products to leather manufacturers throughout the United States with the same product mix and geographic diversity as it has historically maintained.

3. Summary of Significant Accounting Policies

a. The Company uses the accrual basis whereby revenue is recognized as earned and expenses when incurred.
b. The company's policy is to expense advertising as incurred.
c. Depreciation is recorded on a straight-line basis over the assets estimated useful lives.

Manufacturing equipment	5 years
Office fixtures	7 years
Technology equipment and software	3 years

d. Inventories are valued at cost using the first-in, first-out basis, not in excess of market value.

4. Hypothetical Assumption- Increase in Production Capacity by Construction of a New Plant

The projection is based on the assumption that production capacity will be increased by approximately 25 percent by the construction of a new 250,000 square foot production facility in Burlington, Massachusetts.

If the company decides to construct the plant, the construction is projected to begin in May 20X1 and to be completed in November 20X1, at a total cost of $5 million. The production cost estimate and the projected beginning and completion date have been estimated based on construction bids received from potential construction companies.

5. Summary of Significant Projection Assumptions

The projection reflects the following management assumptions.

a. Sales:

The Company's market share is projected to increase from 6 percent of the United States market in 20X0 to 8 percent and 9 percent, respectively, in 20X1 and 20X2. As a result of a forecasted increase in market share, sales are forecasted to increase 15 percent from 20X0 to 20X1, and 20 percent from 20X1 to 20X2, ***if the plant expansion is consummated.***

The credit terms of trade receivables are projected to remain steady at 45 days for 20X1 and 20X2.

b. Cost of sales:

Materials: Materials used by the Company are expected to be readily available in both 20X1 and 20X2. The unit costs of prime material purchases are projected to increase by 2 percent per year based on information from trade associations.

Labor: Approximately 90 percent of the Company's manufacturing labor is represented under a collective bargaining agreement with the Leather Manufacturers' Union. The union contract was negotiated in 20X0 for a three-year period through April 20X3. Labor costs for 20X1 and 20X2 are projected based on the terms of the union contract.

c. Inventories:

Inventories are projected to be maintained at levels to accommodate projected sales volume ***if the plant expansion occurs***. The projection reflects inventory levels to maintain approximately a 90-day supply of inventory and a turnover of 4 for each projection period.

Consistent with the company's practice, the timing of the payment of purchases assumes that all purchase discounts will be taken. Accounts payable are assumed to be maintained at 15 days outstanding for each projection period.

d. Property and equipment:

Projected additions to property and equipment (exclusive of the assumed plant expansion) total $56,000 in 20X1 and $50,000 in 20X2, comprising principally of new computer-based manufacturing equipment. ***Depreciation on the new facility is projected on a straight-line basis over twenty years.***

e. Debt:

The projection reflects the following debt transactions:

1. The Company plans to maintain its $10,000 line of credit with No Loan Bank and Trust***. Regardless of whether the plant expansion occurs***, the Company will be required to borrow additional amounts on the line totaling $1,000 in 20X1 and $3,000 in 20X2, resulting in loan balances of $4,000 and $7,000 at December 31, 20X1 and 20X2, respectively. Interest is forecasted at the prime rate of 8% throughout the forecast periods.

2. Term loans: The company plans to borrow a portion of the funds required to purchase additional property and equipment ***(exclusive of the proposed plant expansion)***, with the remainder of the purchase price being funded through cash. Additional term loans are forecasted to be $6,500 in 20X1 and $13,000 in 20X2 with a five-year amortization at a fixed interest rate of 8% per annum. Principal payments under all term loans are forecasted at $1,500 in 20X1 and $2,000 in 20X2.

3. ***The Company projects additional long-term financing of $4 million to finance the planned plant expansion and has entered into preliminary negotiations with one particular bank for this financing. Based on the preliminary negotiations, the Company has assumed that the additional long-term financing will be amortized over twenty years and bear interest at 8 percent per year.***

f. Income taxes:

The provision for income taxes is computed using statutory rates in effect for 20X1 and 20X2, which are not expected to change. The projection assumes an effective federal and state income tax rate of 40% per year. Deferred income taxes are computed based on temporary differences between the basis of assets and liabilities for tax and financial statement purposes.

g. Selling, general and administrative expenses:

Expenses are projected on an individual expense basis using the following significant assumptions:

1. Salaries will increase by 3 percent per year. Two additional sales positions and three general office positions will be filled in early 20X2, with no additional positions required in 20X1.

2. Occupancy costs ***(exclusive of depreciation on the proposed plant expansion)*** including rent, depreciation, insurance and utilities are projected to increase by 5 percent per year***. Regardless of whether a plant expansion occurs,*** the company would be required to maintain a lease on its manufacturing and office facility through 20X5, requiring a lease payment increase of 5 percent in 20X1 and 35 percent in 20X2.

3. Transportation costs: Because of continued increases in transportation costs including national trucking, the Company projects increases in transportation costs of 10 percent for each projection period.

4. The forecast reflects a 3 percent increase in all other selling, general and administrative expenses in each forecast period.

-The end of report-

Observation-Example 5: Example 5 illustrates the compilation of a financial projection. In order for there to be a projection (versus a forecast), there must be at least one hypothetical assumption on which the entire projection is based. The hypothetical assumption is the basis for a "what if" scenario. In the above example, the hypothetical assumption is that the company will obtain financing to expand its plant facility. Because the additional financing and expanded plant are not necessarily the expected course of action, the engagement is a projection, not a forecast. A forecast is the specific course of action expected to be followed.

A few observations regarding Example 5:

1. The report is changed to include two required items.

   a. A statement describing the special purpose for which the projection was prepared.

   b. A separate paragraph that restricts the use of the report because it is intended to be used solely by the specified parties.

Should a legend be placed on each page of a forecast or projection?

Similar to what has become generally accepted with respect to historical financial statements, each page of prospective financial statements should have a legend.

The AICPA Guide states:

> *"Each page of a financial forecast should contain a statement that directs the reader to the summaries of significant assumptions and accounting policies."*

The AICPA Guide includes the following legend on each page of its sample prospective financial statements:

> *See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.*

If there are projected financial statements, the legend would be changed to:

> *See accompanying Summary of Significant Projection Assumptions and Accounting Policies.*

Further, if a compilation report is issued, the author believes that the requirement in SSARS No. 19 should be followed to place the legend *"See Accountant's Compilation Report"* on each page of the financial statements, even though SSAE No. 10 and not SSARS No. 19, is the governing authority for this kind of compilation engagement.

H. Examination of Prospective Financial Statements

1. General

You have to be crazy to issue an examination report on Prospective Financial Statements!
[The Author]

The above quote sums up the author's opinion about issuing an examination report on prospective financial statements. Although SSAE No. 10 authorizes an accountant to perform an examination on prospective financial statements, the author recommends that the accountant refrain from doing so. Because of the uncertainty of the ultimate outcome of prospective financial statements, performing a higher level of service such as an examination is very risky. If the forecast or projection results do not come to fruition and a third party is damaged, you can be sure the third party will be seeking recovery of damages from the accountant. Moreover, through experience, most third parties will accept forecasted or projected financial statements that have been compiled, rather than examined.

An examination of prospective financial statements involves the following steps:

1. Evaluate the preparation of the prospective financial statements.

2. Evaluate the support underlying the assumptions.

3. Evaluate the presentation of the prospective financial statements for conformity with the AICPA Auditing and Accounting Guide, *Prospective Financial Information.*

4. Issue an examination report.

The examination report gives an opinion as to whether:

a. The prospective financial statements are presented in conformity with the AICPA guidelines found in the AICPA Auditing and Accounting Guide, and

b. The assumptions provide a reasonable basis for the responsible party’s forecast, or whether the assumptions provide a reasonable basis for the party’s projection given the hypothetical assumptions.

In conducting an examination, the accountant must follow the general fieldwork, and reporting standards for Attestation Standards previously discussed in this course.

Further, the accountant's working papers should be appropriate to the circumstances and should indicate that the work was adequately planned and supervised, the entity's process for developing its prospective financial statements was considered in determining the scope of the examination, and there was sufficient evidence obtained to provide a reasonable basis for the report.

2. The Examination Report

SSAE No. 10 provides a sample of an examination report for both a forecast and projection, as the following illustrates:

Sample Report: Examination on Financial Forecast

Independent Accountant's Report

Board of Directors
XYZ Company

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending.

XYZ Company's management is responsible for the forecast. Our responsibility is to express an opinion on the forecast based on our examination.

Our examination was conducted in accordance with Attestation Standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the accompanying forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

James J. Fox & Company, CPA
March 1, 20XX

When examining a projection, the opinion regarding the assumptions should be based on whether the assumptions provide a reasonable basis for the projection given the hypothetical assumptions. In addition to the elements included in the forecast report, the projection report should include two items:

a. A statement describing the special purpose for which the projection was prepared, and

b. A separate paragraph that restricts the use of the report to the specified parties.

Sample Report: Examination on Projection

Independent Accountant's Report

Board of Directors
XYZ Company

We have examined the accompanying projected balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending.

XYZ Company's management is responsible for the projection which was prepared for the purpose of negotiating a loan to expand XYZ Company's plant investment. Our responsibility is to express an opinion on the projection based on our examination.

Our examination was conducted in accordance with Attestation Standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the projection. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the accompanying projection is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's projection, assuming the granting of the requested loan for the purpose of expanding XYZ Company's plant investment as described in the summary of significant assumptions. However, even if the loan is granted and the plant is expanded, there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

The accompanying projection and this report are intended solely for the information and use of XYZ Company and No Loan Bank and is not intended to be and should not be used by anyone other than these specified parties.

James J. Fox & Company, CPA
March 1, 20XX

What is the date on the examination report?

Like an audit of historical financial statements, the report date is the date of completion of the examination procedures.

a. Modification of the examination report

The following chart depicts circumstances in which the accountant's examination report should be modified.

Description of circumstances	Report modification
The prospective financial statements depart from the AICPA presentation guidelines.	Qualified or adverse opinion, depending on the severity of the departure.
The prospective financial statements fail to disclose significant assumptions.	Adverse opinion and describe the significant assumptions in the report.
One or more significant assumptions do not provide a reasonable basis for the forecast or projection.	Adverse opinion.
One or more significant assumptions do not provide a reasonable basis for the projection given the hypothetical assumptions.	Adverse opinion.
Examination is affected by conditions that preclude application of one or more procedures that are considered necessary in the circumstances.	Disclaim an opinion and describe the scope limitation in the report.

An accountant should not examine a presentation that omits all disclosures of assumptions. Further, the accountant should not examine a financial projection that omits the identification of the hypothetical assumptions, and a description of the limitations on the usefulness of the presentation.

If a qualified opinion is given, the report should present in a separate paragraph, all substantive reasons for the report modification including a description of the departure from the AICPA Accounting and Auditing Guide.

Sample Report: Examination on Financial Forecast – Qualified Opinion

Independent Accountant's Report

Board of Directors
XYZ Company

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending.

XYZ Company's management is responsible for the forecast. Our responsibility is to express an opinion on the forecast based on our examination.

Our examination was conducted in accordance with Attestation Standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast. We believe that our examination provides a reasonable basis for our opinion.

The forecast does not disclose significant accounting policies. Disclosure of such policies is required by guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants.

In our opinion, ***except for the omission of the disclosure of the significant accounting policies as discussed in the preceding paragraph,*** the accompanying forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

James J. Fox & Company, CPA
March 1, 20XX

Sample Report: Examination on Financial Forecast – Disclaimer of Opinion

<u>Independent Accountant's Report</u>

Board of Directors
XYZ Company

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending.

XYZ Company's management is responsible for the forecast. Our responsibility is to express an opinion on the forecast based on our examination.

As discussed under the caption "Income From Investee" in the summary of significant forecast assumptions, the forecast includes income from an equity investee constituting 23 percent of forecasted net income, which is management's estimate of the Company's share of the investee's income to be accrued for 20XX. The investee has not prepared a forecast for the year ending December 31, 20XX, and we were therefore unable to obtain suitable support for this assumption.

Because, as described in the preceding paragraph, we are unable to evaluate management's assumption regarding income from an equity investee and other assumptions that depend thereon, the scope of our work was not sufficient to express, and we do not express, an opinion with respect to the presentation of or the assumptions underlying the accompanying forecast. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

James J. Fox & Company, CPA
March 1, 20XX

b. Other circumstances requiring a modification to the standard examination report

There are circumstances in which the standard examination report should be modified, including the following:

1. Emphasis of a matter.
2. Evaluation based in part on another accountant's report.
3. Comparative historical financial information.
4. When the examination is part of a larger engagement, such as a feasibility or business acquisition study.

c. Examination is part of a larger engagement

An examination of prospective financial statements may be included as part of a larger engagement such as a business plan, feasibility or acquisition study. In such cases, it is appropriate to expand the report to describe the larger engagement. The following is a sample report that might be issued when an examination is part of a feasibility study.

Example – Feasibility Study

Independent Accountant's Report

To the Board of Directors
Example Hospital
Example, Texas

We have prepared a financial feasibility study of Example Hospital's (the Hospital's) plans to expand and renovate its facilities. The study was undertaken to evaluate the ability of the Hospital to meet its operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed $25,000,000 issue, at an assumed average annual interest rate of 10 percent during the five years ending December 31, 20X6.

The proposed capital improvements program (the Program) consists of a new two-level addition, which is to provide fifty additional medical-surgical beds, increasing the complex to 275 beds. In addition, various administrative and support service areas in the present facilities are to be remodeled. The Hospital administration anticipates that construction is to begin June 30, 20X2, and to be completed by December 31, 20X3.

The estimated total cost of the Program is approximately $30,000,000. It is assumed that the $25,000,000 of revenue bonds that the Example Hospital Finance Authority proposes to issue would be the primary source of funds for the Program. The responsibility for payment of debt service on the bonds is solely that of the Hospital. Other necessary funds to finance the Program are assumed to be provided from the Hospital's funds, from a local fund drive, and from interest earned on funds held by the bond trustee during the construction period.

Our procedures included analysis of the following:

1. Program history, objectives, timing and financing.
2. The future demand for the Hospital's services, including consideration of the following:
    a. Economic and demographic characteristics of the Hospital's defined service area.
    b. Locations, capacities, and competitive information pertaining to other existing and planned area hospitals.
    c. Physician support for the Hospital and its programs.

d. Historical utilization levels.

e. Planning agency applications and approvals.

f. Construction and equipment costs, debt service requirements, and estimated financing costs.

g. Staffing patterns and other operating considerations.

h. Third-party reimbursement policy and history.

i. Revenue-expense-volume relationships.

We also participated in gathering other information, assisted management in identifying and formulating its assumptions, and assembled the accompanying financial forecast based on those assumptions.

The accompanying financial forecast for the annual periods ending December 31, 20X2, through 20X6, is based on assumptions that were provided by or reviewed with and approved by management. The financial forecast included the following:

- Balance sheets
- Statements of operations
- Statements of cash flows
- Statements of changes in net assets

We have examined the financial forecast. Example Hospital's management is responsible for the forecast. Our responsibility is to express an opinion on the forecast based on our examination. Our examination was conducted in accordance with Attestation Standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast. We believe that our examination provides a reasonable basis for our opinion.

Legislation and regulations at all levels of government have affected and may continue to affect revenues and expenses of hospitals. The financial forecast is based on legislation and regulations currently in effect. If future legislation or regulations to hospital operations are enacted, such legislation or regulations could have a material effect on future operations.

The interest rate, principal payments, program costs, and other financing assumptions are described in the section entitled "Summary of Significant Forecast Assumptions and Rationale." If actual interest rates, principal payments, and funding requirements are different from those assumed, the amount of the bond issue and debt service requirements would need to be adjusted accordingly from those indicated in the forecast. If such interest rates, principal payments, and funding requirements are lower than those assumed, such adjustments would not adversely affect the forecast.

Our conclusions are presented below:

1. In our opinion, the accompanying financial forecast is presented in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants.

2. In our opinion, the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

3. The accompanying financial forecast indicates that sufficient funds could be generated to meet the Hospital's operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed $25,000,000 bond issue, during the forecast periods. However, the achievement of any financial forecast is dependent on future events, the occurrence of which cannot be assured.

We have no responsibility to update this report for events and circumstances occurring after the date of this report.

James J. Fox & Company, CPA
Date:

d. Historical financial statements included with prospective financial statements

It is quite common and perhaps more meaningful to present historical and prospective financial statements together either comparatively, or separately but within the same report binder. By doing so, the client or third parties can evaluate how a company has performed relative to the budget.

The presentation and reporting requirements related to this scenario depend on how the information is presented and whether the budgeted information has expired or not.

The author addresses several situations in which prospective and historical financial information are presented either comparatively or within the same binder.

1. Prospective financial information is presented comparatively with historical financial information for an expired period.

2. Prospective financial information is presented with historical financial information for an unexpired period.

3. Prospective financial statements are presented for the current unexpired year comparatively with historical financial statements for the prior year.

4. Prospective financial statements are presented in the same package as the historical financial statements, but not on the same pages.

Scenario 1: Prospective financial information is presented comparatively with historical financial information for an expired period

Let's look at some facts.

Example: Johnny Jones, CPA prepared a compiled forecast for XYZ Company for the year ended December 31, 20X1. At the end of the year, Johnny prepares compiled historical financial statements for the year and decides to present a column on the income statement showing the forecasted income statement, for comparative purposes.

Should Johnny's report include a compilation of the historical financial statements under SSARS No. 19, and a separate compilation report on forecasted financial statements under SSAE No. 10?

Response: No. Because the forecast (budget) period has expired, the forecasted information is no longer considered prospective information covered under SSAE No. 10. The result is that the forecasted information should be treated as **supplementary information in accordance with SSARS No. 19.**

The following is a sample report that illustrates this situation.

Report When Compiled Historical Financial Statements Are Accompanied by a Budgeted Income Statement for an Expired Period

Accountant's Compilation Report

Board of Directors
XYZ Company

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

The supplementary budget information is presented for purposes of additional analysis and is not a required part of the basic financial statements. The supplementary budget information has been compiled from information that is the representation of management. We have not audited or reviewed the supplementary budget information and, accordingly, do not express an opinion or provide any assurance on such supplementary budget information.

Management has elected to omit substantially all disclosures required by accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the financial statements, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company, CPA
Date:

Sample Statement of Income

XYZ Corporation
Statements of Income and Retained Earnings
For the Year Ended December 31, 20XX and Budgeted
Information for the Year Ended December 31, 20XX
(See Accountant's Compilation Report)

	Actual	Budgeted	Variance Over (Under) Net Income
Net sales	$500,000	$666,000	$-166,000
Cost of sales	340,000	440,000	100,000
Gross profit on sales	160,000	226,000	-66,000
Selling, general and administrative expenses	90,000	166,000	76,000
Net operating income	70,000	60,000	10,000
Other income, net	10,000	8,000	2,000
Income before income taxes	80,000	68,000	12,000
Income taxes	32,000	36,000	4000
Net income	48,000	32,000	16,000
Retained earnings:			
Beginning of year	128,000	128,000	-0-
End of year	$176,000	$160,000	$16,000

Observation: If footnotes were included for the historical financial statements, there is no need to include any information on the budgeted financial information. Meaning, the summary of significant assumptions and policies would not be included since they apply only to prospective financial statements. Once the prospective period expires, the information is no longer prospective and, instead, is supplementary information just like any other supplementary information (e.g., schedule of operating expenses, etc.).

Scenario 2: Prospective financial information is presented comparatively with historical financial information for an unexpired period

An accountant may be asked to present prospective financial information for an unexpired period with historical financial information. The prospective information may be included side by side on the same pages as the historical financial statements, or on separate pages within the same binder.

In such situations, there is a hybrid in which the historical financial information is covered by SSARS No. 19, while the prospective information is covered by SSAE No. 10. A common example of where the combining of prospective and historical financial statements is useful, is with respect to not-for-profit organizations, whereby management wishes to know the unexpired portion of a budget left to spend.

Example: Johnny Jones, CPA prepares a twelve-month forecast (budget) for the year ended December 31, 20XX. After six months, Johnny compiles a six-month historical statement for the six-month period ended June 30, 20XX. Johnny wishes to show the six-month historical financial statements comparative with the twelve-month forecast, for which a portion is unexpired.

What are the reporting requirements?

Response: The AICPA's Guide, *Prospective Financial Information,* provides guidance on this situation. The general rule is that when an accountant has compiled, reviewed or audited historical financial statements that are included in an accountant-submitted document that also contains the prospective financial statements, the accountant should also examine, compile, or apply agreed-upon procedures to the prospective financial statements.

However, if budgeted financial information for an unexpired period is **presented along with historical financial statements,** there is a special provision found in the AICPA Audit and Accounting Guide.

- The CPA may report on the historical statements under SSARS No. 19, and

- **Disclaim** on the prospective budgeted financial information.

This exception applies where the following requirements are met:

a. The prospective financial statements must be labeled as a “budget.”

b. The budget does not extend beyond the end of the current fiscal year.

c. The budget must be presented with interim historical financial statements for the current year.

If the above criteria are met, the accountant **is not required** to:

a) Apply compilation, agreed-upon, or examination procedures to the prospective budgeted financial information, even if the information is intended for third parties.

b) Disclose significant assumptions or accounting policies that would ordinarily be required for prospective budgeted information, provided the omission of this information is not, to the CPA's knowledge, undertaken with the intention of misleading those who might use it.

The accountant's report would indicate that he or she did not examine or compile the budgeted information and, **disclaims an opinion** or any other form of assurance on the budget.

Example: A company issues historical financial statements for the six-month period ending June 30, 20XX comparatively with prospective statements for the year ended December 31, 20XX. The only information shown comparatively is the statement of income and schedule of operating expenses. The report would look like the following:

Compilation Report: Six Months Historical Financial Statements and Twelve Months Prospective Financial Statements Accountant's Compilation Report[3]

Board of Directors
XYZ Company

We have compiled the accompanying balance sheet of XYZ Corporation as of June 30, 20XX, and the related statements of income, retained earnings and cash flows for the six-month period then ended, and the accompanying schedule of selling, general and administrative expenses, which are presented for supplementary analysis purposes only. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

The accompanying budget of XYZ Corporation for the year ending December 31, 20XX, has not been compiled or examined by us, and, accordingly, we do not express an opinion or any other form of assurance on it.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

Management has elected to **omit from the historical financial statements substantially all disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America, and from the budgeted financial statements, the summaries of significant assumptions and accounting policies required under established guidelines for presentation of prospective financial statements.** If the omitted disclosures were included in the historical and budgeted information, they might influence the user's conclusions about the Company's financial position, results of operations, and cash flows. Accordingly, the accompanying financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company, CPA
Date:

[3] Report title is required because the compilation report involves historical financial statements and is covered under SSARS No. 19. SSARS No. 19 requires a report title for a compilation report while SSAE No. 10 does not.

XYZ Corporation.
Balance Sheet
June 30, 20XX
(See Accountant's Compilation Report)

ASSETS	
Current assets:	
Cash and equivalents	$3,000
Accounts receivable, net of allowance	65,000
Inventories	42,000
Prepaid expenses and other current assets	5,000
Total current assets	115,000
Property and equipment:	
Cost	155,000
Less accumulated depreciation	25,000
Total property and equipment	130,000
Other assets:	6,000
	$251,000
LIABILITIES AND EQUITY	
Current liabilities:	
Accounts payable	$28,000
Accrued expenses and taxes	6,000
Notes payable- bank	7,000
Current portion of long-term debt	2,000
Total current liabilities	43,000
Long-term debt, net of current portion:	28,000
Deferred income taxes	3,000
Stockholders' equity:	
Common stock	1,000
Retained earnings	176,000
Total stockholders' equity	177,000
	$251,000

XYZ Corporation
Statements of Income and Retained Earnings
For the Six Months Period Ended June 30, 20XX and Budgeted
Information for the Year Ended December 31, 20XX
(See Accountant's Compilation Report)

	(Actual) Compiled Six-Month Period Ended June 30, 20XX	(Budgeted) Year Ended December 31, 20XX	Variance Over (Under) Net Income
Net sales	$500,000	$666,000	$(166,000)
Cost of sales	340,000	440,000	100,000
Gross profit on sales	160,000	226,000	(66,000)
Selling, general and administrative expenses	90,000	166,000	76,000
Net operating income	70,000	60,000	10,000
Other income, net	10,000	8,000	2,000
Income before income taxes	80,000	68,000	12,000
Income taxes	32,000	36,000	4000
Net income	48,000	32,000	16,000
Retained earnings:			
Beginning of year	128,000	128,000	-0-
End of year	$176,000	$160,000	$16,000

XYZ Corporation
Schedules of Selling, General and Administrative Expenses
For the Six-Month Period Ended June 30, 20XX and Budgeted Information
for the Year Ended December 31, 20XX
(See Accountant's Compilation Report)

	(Actual) Compiled Six-Month Period Ended June 30, 20XX	(Budgeted) Year Ended December 31, 20XX	Variance Over (under)
Advertising	$5,000	$6,000	$(1,000)
Shipping and delivery	2,000	3,000	(1,000)
Professional fees	3,000	4,000	(1,000)
Office expenses	4,000	3,500	500
Repairs and maintenance	6,000	8,000	(2,000)
Depreciation and amortization	7,000	14,000	(7,000)
Salaries and wages	20,000	38,000	(18,000)
Payroll taxes	2,000	4,000	(2,000)
Retirement plan costs	3,000	5,500	(2,500)
Fringe benefits	4,000	8,500	(4,500)
Interest	10,000	22,000	(12,000)
Local taxes	500	1,000	(500)
Commissions	3,500	6,000	(2,500)
Insurance	1,500	2,800	(1,300)
Equipment rents	2,000	4,200	(2,200)
Real estate rents	9,000	19,000	(10,000)
Security	1,000	2,500	(1,500)
Sundry other expenses	500	1,500	(1,000)
Travel	2,500	6,000	(3,500)
Motor vehicle expenses	3,500	6,500	(3,000)
	$90,000	$166,000	$(76,000)

Observation: The above example illustrates the exception available when budgeted financial information is presented side by side with historical information. The exception applies if three requirements are met:

1. The prospective financial statement is labeled as a “budget.”
2. The budget does not extend beyond the end of the current fiscal year.
3. The budget is presented with interim (six-month) historical financial statements for the current year.

The previous example fulfills all three requirements.

Change the facts: If instead, compiled historical financial statements are issued that include notes and the statement of cash flows, and only the summary of significant assumptions and accounting policies are omitted, the report language would be changed to the following:

Fourth paragraph of report:

> Management has ***elected to omit the summaries of significant assumptions and accounting policies*** required under established guidelines for presentation of prospective financial statements. If the omitted summaries were included in the budgeted information, they might influence the user's conclusions about the company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.

Conclusion: The accountant may present the six-month ending June 30, 20X1 interim statements along with comparatively presenting the twelve-month unexpired budget for the year ended December 31, 20X1.

What is the reporting requirement if the special disclaimer exception is not available?

If the three criteria under the special disclaimer exception are not met, the exception does not apply. Remember that the general rule is that when an accountant has compiled, reviewed or audited historical financial statements that are included in an accountant-submitted document that also contains the prospective financial statements, the accountant should also examine, compile, or apply agreed-upon procedures to the prospective financial statements. The result is that the accountant must report separately on both the historical and prospective financial statements. Further, the prospective financial statements require that a summary of significant assumptions be presented.

Although the historical financial statements may be reported on at a different level of service than the prospective financial statements, the likely scenario is that both the historical and prospective financial statements will be compiled.

The following fact pattern illustrates this point.

Example: Harry Callahan CPA's client requests that the six-month historical statements be presented along with a five-year forecast.

Conclusion: Because the budgeted information **extends beyond the current year,** the special disclaimer **exception is not available.** Consequently, Harry *must comply* with the reporting requirements for both the historical and prospective financial statements. The report looks like the following:

Compilation Report: Six-Month Historical Financial Statements and Five-Year Prospective Financial Statements

Accountant's Compilation Report

Board of Directors
XYZ Company

We have compiled the accompanying balance sheet of XYZ Company as of June 30, 20X1, and the related statements of income, retained earnings and cash flows for the six month period then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

We also have compiled the accompanying forecasted balance sheets, statements of income and retained earnings, and cash flows of XYZ Corporation as of December 31, 20X1, 20X2, 20X3, 20X4 and 20X5, and for each year then ending, in accordance with Attestation Standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of a forecast, information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Harry Callahan and Company, CPA
Date:

Observation: In the above example where there is reporting on both the historical and prospective financial statements, there is the requirement to include a summary of significant assumptions and accounting policies. Management may elect out of the accounting policies by including an additional paragraph noting so; however, there is no option to elect not to include the significant assumptions.

Scenario 3: Prospective financial statements are presented for the current unexpired year comparatively with historical financial statements for the prior year

Another scenario occurs where the prior year historical financial statements are presented comparatively with the current year prospective financial statements. In this case, should the report be based primarily on the forecast or projection with reference to the historical information, or be based primarily on the historical information with reference to the forecasted or projected comparative information?

The format of the report depends on which statement is the dominant statement. That is, is the company preparing a forecast with historical information for comparative purposes only, or are the financial statements historical with forecasted information for comparative purposes?

Let's look at the following example:

Facts: Company X is preparing a forecast for the year ended December 31, 20X2 and wishes to present the historical information for the year ended 20X1 for comparative purposes only.

Conclusion: It appears that the forecast is the predominant presentation with the historical information presented for comparative purposes only. Thus, the accountant's report should present the forecast with reference to the historical information presented for comparative purposes.

Board of Directors
XYZ Corporation

We have compiled the accompanying forecasted balance sheet, statement of income and retained earnings, and cash flows of XYZ Corporation as of December 31, 20X2, and for the year then ending, and the accompanying schedule of operating expenses, which is presented for supplementary information purposes only, in accordance with Attestation Standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of a forecast, information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

We have also compiled the accompanying historical balance sheet, statement of income and retained earnings, and cash flows of XYZ Corporation as of December 31, 20X1 and for the year then ending, and the accompanying schedule of operating expenses, which is presented for supplementary information purposes only, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation of historical financial statements is limited to presenting in the form of financial statements and supplementary schedules, information that is the representation of management. We have not audited or reviewed the accompanying 20X1 historical statements and schedule and, accordingly, do not express an opinion or any other form of assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

James J. Fox & Company, CPA
March 1, 20X2

XYZ Corporation
Forecasted Balance Sheet
December 31, 20X2
(Comparative Historical Information as of December 31, 20X1)
(See Accountant's Compilation Report)

	Comparative Historical Information 20X1	Forecasted 20X2
ASSETS		
Current assets:		
Cash and equivalents	$3,000	$4,000
Accounts receivable, net of allowance	60,000	65,000
Inventories	40,000	42,000
Prepaid expenses and other current assets	4,000	5,000
Total current assets	107,000	116,000
Property and equipment:		
Cost	100,000	150,000
Less accumulated depreciation	17,000	25,000
Total property and equipment	83,000	125,000
Other assets:	5,000	6,000
	$195,000	$247,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$24,000	$28,000
Accrued expenses and taxes	5,000	6,000
Notes payable- bank	4,000	7,000
Current portion of long-term debt	1,000	2,000
Total current liabilities	34,000	43,000
Long-term debt, net of current portion:	30,000	40,000
Deferred income taxes	2,000	3,000
Stockholders' equity:		
Common stock	1,000	1,000
Retained earnings	128,000	160,000
Total stockholders' equity	129,000	161,000
	$195,000	$247,000

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

XYZ Corporation
Forecasted Statement of Income and Retained Earnings
For the Year Ended December 31, 20X2
(Comparative Historical Information for the Year Ended December 31, 20X1)
(See Accountant's Compilation Report)

	Comparative Historical Information 20X1	Forecasted 20X2
Net sales	$500,000	$600,000
Cost of sales	340,000	440,000
Gross profit on sales	160,000	160,000
Selling, general and administrative expenses	90,000	100,000
Net operating income	70,000	60,000
Other income, net	10,000	8,000
Income before income taxes	80,000	68,000
Income taxes	32,000	36,000
Net income	48,000	32,000
Retained earnings:		
Beginning of year	80,000	128,000
End of year	$128,000	$160,000

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

XYZ Corporation
Forecasted Statement of Cash Flows
For the Year Ended December 31, 20X2
(Comparative Historical Information For the Year Ended December 31, 20X1)
(See Accountant's Compilation Report)

	Comparative Historical Information 20X1	Forecasted 20X2
Cash flows from operating activities:		
Net income	$48,000	$32,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	6,000	8,000
Deferred income taxes	(2,000)	1,000
Change in:		
Accounts receivable	(3,000)	(5,000)
Inventories	(4,000)	(2,000)
Prepaid expenses and other assets	1,000	(2,000)
Accounts payable	7,000	4,000
Accrued expenses and taxes	(1,000)	1,000
Net cash provided by operating activities	52,000	37,000
Cash flows used for investing activities:		
Purchases of property and equipment	(56,000)	(50,000)
Net cash used for investing activities	(56,000)	(50,000)
Cash flows from financing activities:		
Proceeds from bank loans	1,000	3,000
Proceeds from long-term borrowings	6,500	13,000
Repayment of long-term debt	(1,500)	(2,000)
Net cash from financing activities	6,000	14,000
Net increase in cash and cash equivalents	2,000	1,000
Cash and cash equivalents:		
Beginning of year	1,000	3,000
End of year	$3,000	$4,000

See accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

XYZ Corporation
Forecasted Schedule of Selling, General and Administrative Expenses
For the Year Ended December 31, 20X2
(Comparative Historical Information For the Year Ended December 31, 20X1)
(See Accountant's Compilation Report)

	Comparative Historical Information 20X1	Forecasted 20X2
Advertising	$5,000	$6,000
Shipping and delivery	2,000	3,000
Professional fees	3,000	4,000
Office expenses	4,000	3,500
Repairs and maintenance	6,000	8,000
Depreciation and amortization	7,000	14,000
Salaries and wages	20,000	38,000
Payroll taxes	2,000	4,000
Retirement plan costs	3,000	5,500
Fringe benefits	4,000	8,500
Interest	10,000	22,000
Local taxes	500	1,000
Commissions	3,500	6,000
Insurance	1,500	2,800
Equipment rents	2,000	4,200
Real estate rents	9,000	19,000
Security	1,000	2,500
Sundry other expenses	500	1,500
Travel	2,500	6,000
Motor vehicle expenses	3,500	6,500
	$90,000	$166,000

See accompanying Summary of Significant Forecast Assumptions
and Accounting Policies.

Observations: The above forecasted financial statements would be accompanied by a summary of significant forecast assumptions and accounting policies. As for presenting this information comparatively for the 20X1 historical data, the only information that would include comparative 20X1 historical information would be the summary of significant accounting policies.

Scenario 4: Prospective financial statements are included in the same packet as historical financial statements, but not included in the same pages

A fourth scenario where prospective financial statements are co-mingled with historical financial statements is where both are included in the same packet. For example, a forecast report, financial statements and related notes are presented on pages 1-10, and the historical financial statements and related report are presented on pages 11-15.

SSAE No. 10 states that in such instances, the prospective financial statements should be clearly labeled to preclude a reader from confusing them with historical financial statements.

Does this mean that any modifications need to be made to the report on the prospective financial statement? Probably not. What is important is that the sections related to the prospective financial statements and the historical financial statements be separated and that each report is included in each related section.

The following is a chronology of pages that illustrates a situation where both prospective financial statements and historical financial statements are presented in the same package.

<u>Sample Layout of Pages: Both Prospective and Historical Financial Statements Included in the Same Packet</u>:

Page 1	Table of Contents
Page 2	Compilation Report on Financial Forecast
Pages 3-6	Forecasted Statements and Schedule: Balance Sheet, Statement of Income Retained Earnings, Statement of Cash Flows, and Schedule of Operating Expenses.
Pages 7-8	Summary of Significant Forecast Assumptions and Accounting Policies.
Page 9	Separation Page: with the following printed on it: *Historical Financial Statements and Compilation Report Thereon* *For the Year Ended December 31, 20XX*
Page 10	Compilation Report on Historical Financial Statements
Pages 11-13	Historical Financial Statements: Balance Sheet, Statement of Income and Retained Earnings, Schedule of Operating Expenses.

Note: The above presentation assumes that management has elected to omit the statement of cash flows and substantially all disclosures required by GAAP. If not, additional pages from 14 on would be included. In the previous layout, there would be no requirement to make reference to the historical financial information in the report on prospective financial statements, or vice versa.

Special rule where condensed historical financial information is included in the prospective financial statements

In limited cases, a condensed version of the historical financial statements may be shown comparatively within the prospective financial statements. If this occurs, SSAE No. 10 states that a reference to the historical financial statements from which the condensed information was obtained, should be included in the report on prospective financial information. The following suggested language is illustrated in SSAE No. 10.

Paragraph included in the compilation report on prospective financial statements:

> *The historical financial statements for the year ended December 31, 20XX, from which the historical data are derived, and our report thereon are set forth on pages xx-xx of this document.*

SSAE No. 10 does not address the situation where condensed historical information is included in the prospective financial statements, but the full set of historical financial statements is not included in the same financial statement package. In such cases, the author believes that the above paragraph should be changed to the following:

> *The historical financial statements for the year ended December 31, 20XX, from which the historical data are derived*, ***were compiled by us in our report dated xxxx.***

Review Questions

The following questions are designed to ensure that you have a complete understanding of the information presented in the course material. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions.

1. Whenever an accountant submits to his or her client reports on prospective financial statements that he or she has assembled that are reasonably expected to be used by another third party, the accountant should not issue which of the following reports:

   a) a compilation
   b) an examination
   c) a plain paper engagement
   d) a partial presentation

2. In practice, what term is used to identify prospective financial information:

   a) “budget”
   b) “financial forecast”
   c) “financial projection”
   d) “pro forma information”

3. When the responsible party is not negotiating directly with the persons who will be using the prospective financial statements, how would the use be classified:

   a) general use
   b) internal use
   c) limited use
   d) responsible use

4. What is required in the presentations of both historical financial statements and prospective financial statements:

   a) footnotes
   b) introduction paragraph describing what the statements will present
   c) summary of significant accounting policies
   d) summary of significant assumptions

5. What step in performing a compilation of prospective financial statements follows establishing an understanding with the client concerning the services to be performed:

   a) confirmation of understanding of statements
   b) inquiry of accounting principles used
   c) issuance of a compilation report
   d) receipt of a list of assumptions used

6. What should the engagement letter in a compilation of prospective financial statements include:

   a) a statement that the assumptions are reasonable
   b) a statement that the forecast conforms with AICPA guidelines
   c) the accounting principles used
   d) the limitations of the engagement

7. In an examination of prospective financial statements, if the summary of significant accounting policies is omitted:

   a) an adverse opinion is required
   b) either a qualified or adverse opinion is required
   c) it should be disclosed in the notes, but there is no report modification required
   d) the report must be expanded to include an emphasis of a matter paragraph

8. What is the easiest and least time-consuming financial forecast engagement and report to perform:

   a) compilation with a summarized financial forecast and an election to omit the summary of significant accounting policies
   b) compilation with a summarized financial forecast using the minimum elements
   c) examination on a financial forecast
   d) standard compilation report on the financial forecast with accompanying attachments

9. Under what circumstance would the accountant disclaim an opinion and describe the scope limitation in the examination report:

   a) conditions that preclude application of procedures considered necessary affect the examination
   b) one or more significant assumptions do not provide a reasonable basis for the forecast
   c) prospective financial statements deviate from AICPA Accounting and Auditing Guide
   d) significant assumptions are not disclosed in the prospective financial statements

Solutions and Suggested Responses

1. A: Incorrect. A compilation report is an appropriate report if it is being submitted to another third party.

   B: Incorrect. An examination report is an appropriate report if it is being submitted to another third party.

   C: Correct. A plain paper engagement should be used where the financial statements are expected to be used for internal use, but not by an outside third party.

   D: Incorrect. A partial presentation report is an appropriate report if it is being submitted to another third party.

   (See page 2 of the course material.)

2. **A: Correct.** In practice, the term “budget” is often used to identify prospective financial information. A more formal hierarchy is used in the codification of prospective financial statements.

   B: Incorrect. In the codification of prospective financial statements, the term “financial forecast” is used for prospective financial statements presenting the expected financial position, result of operations and cash flows of an entity that are based on assumptions that the responsible party expects.

   C: Incorrect. In the codification of prospective financial statements, the term “financial projection” is used for prospective financial statements that present an entity’s expected financial position, result of operations and cash flows given certain hypothetical assumptions.

   D: Incorrect. The objective of “pro forma information” is to show what the significant effects on historical financial information might have been had a consummated or proposed transaction occurred at an earlier date.

   (See page 3 of the course material.)

3. **A: Correct.** When the responsible party is not negotiating directly with the persons who will be using the prospective financial statements, the use would be classified as general use.

   B: Incorrect. When the responsible party is the only party who will be using the prospective financial statements, the use would be classified as internal use.

   C: Incorrect. When the responsible party alone or the responsible party and third parties with whom the responsible party is negotiating will be using the prospective financial statements, the use would be classified as limited use.

   D: Incorrect. The three classifications of prospective financial statements are: general use, limited use and internal use. The responsible party determines who will use the prospective financial statements.

   (See page 7 of the course material.)

4. A: Incorrect. Footnotes are required in historical financial statements but are not required in prospective financial statements.

   B: Incorrect. Prospective financial statements require an introduction paragraph to describe what the statements will present, state that the assumptions are based on the responsible party's judgment at the time the information was prepared, and caution that the prospective results may not be reached. This requirement is not applicable to historical financial statements.

   C: Correct. In the presentations of both historical financial statements and prospective financial statements, a summary of significant accounting policies is required.

   D: Incorrect. A summary of significant assumptions is required in prospective financial statements but not in historical financial statements.

   (See page 10 of the course material.)

5. A: Incorrect. Confirmation of understanding of statements, including assumptions, by obtaining a written representation letter is the second to final step in performing a compilation of prospective financial statements.

   B: Correct. In performing a compilation of prospective financial statements, an inquiry of accounting principles used in the preparation of the statements is the second step, following establishing an understanding with the client concerning the services to be performed.

   C: Incorrect. The final step in performing a compilation of prospective financial statements is the issuance of a compilation report.

   D: Incorrect. The fourth step in performing a compilation of prospective financial statement is obtaining a list of assumptions used in the statements.

   (See pages 14 to 15 of the course material.)

6. A: Incorrect. The representation letter should include a statement that the assumptions on which the forecast is based are reasonable.

   B: Incorrect. The representation letter should include a statement that the forecast conforms with AICPA guidelines for presentation of a forecast.

   C: Incorrect. The accountant will inquire about the accounting principles used in the preparation of the prospective financial statements after the understanding is obtained.

   D: Correct. The engagement letter in a compilation of prospective financial statements should include: the objectives of the engagement, the client's responsibilities, the accountant's responsibilities, and the limitations of the engagement.

   (See page 16 of the course material.)

7. A: Incorrect. An adverse opinion is required in certain, but not all cases, making the statement inicorrect.

   B: Correct. In an examination of prospective financial statements, if the summary of significant accounting policies is omitted, either a qualified or adverse examination report must be issued.

   C: Incorrect. In a *compilation* of prospective financial statements, if the statements are presented on an other comprehensive basis of accounting, the basis of accounting used should be disclosed in the compilation report.

   D: Incorrect. In a *compilation* of prospective financial statements, if the accountant wishes to expand the report to emphasize a matter, it should be presented in a separate paragraph of the report.

   (See page 28 of the course material.)

8. **A: Correct.** A compilation with a summarized financial forecast and an election to omit the summary of significant accounting policies is the easiest and least time consuming financial forecast and report to issue. The standard financial statements are not presented in this type of forecast.

   B: Incorrect. While issuing a compilation report with a summarized financial forecast using the minimum elements is easier than issuing a compilation with a full set of financial statements, it is not the easiest and least time-consuming. Such an engagement can be simplified further by also omitting the summary of significant accounting policies.

   C: Incorrect. An examination and report thereon is certainly not the easiest type of engagement for a forecast. The accountant must not only follow the general, fieldwork, and reporting standards for Attestation Standards, but is required to perform additional procedures related to the forecast.

   D: Incorrect. A compilation with a full set of financial statements, along with the accompanying attachments, illustrates the most common application of a financial forecast, but certainly not the easiest.

   (See page 48 of the course material.)

9. **A: Correct.** When conditions that preclude application of procedures considered necessary affect the examination, the accountant would disclaim an opinion and describe the scope limitation in the examination report.

   B: Incorrect. When one or more significant assumptions do not provide a reasonable basis for the forecast, the accountant would issue an adverse opinion.

   C: Incorrect. When prospective financial statements deviate from the AICPA Accounting and Auditing Guide, the accountant would issue a qualified or adverse opinion, depending on the severity of the departure.

   D: Incorrect. When significant assumptions are not disclosed in the prospective financial statements, the accountant would issue an adverse opinion and describe the significant assumptions in the report.

   (See page 64 of the course material.)

Glossary

Agreed-upon procedures – A professional services firm is retained to issue a report of findings based on specific procedures performed on subject matter.

Financial forecast – A forecast based on the assumptions reflecting the conditions the responsible party expects will exist and the course of action it expects to take.

Financial projection – Consists of prospective financial statements that present an entity's expected financial position, results of operations, and cash flows given one or more hypothetical assumptions.

Prospective financial statements – Include forecasts and projections. They are one category of prospective financial information. They offer a glimpse into the future by forecasting potential business outcomes.

Specified parties – Those individuals or entities that seek the accountant's involvement in the subject matter. They can include management or any third party.

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