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THE AUDITOR'S ROLE IN FINANCIAL FORECASTS

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Abstract

The goal of this research was to investigate the relationship between auditors and their clients' forward-looking financial information. The paper describes the results of personal interviews with forty-two auditors, in which they discussed their experiences with their clients' forward-looking data and expressed their attitudes and perceptions concerning auditor involvement with the public disclosure of financial forecasts. Based on the data gathered, it is concluded that auditors have considerable experience with their clients' forward-looking data and are therefore prepared to meaningfully contribute their skills to an increase in public exposure of client financial forecasts. At the same time, their attitudes toward increased exposure of forward-looking data are quite divergent, with roughly half favoring and half opposing such a movement. Finally, the paper discusses auditors' main concerns in the area of public financial forecasting.

INTRODUCTION

This paper reports the results of a study involving forty-two audit partners and managers from nine national and regional CPA firms. The research investigated the auditor's current role in financial forecasting and elicited opinions as to his/her future role. The paper begins with a brief history of public forecasting developments, followed by a discussion of the terminoloty used to date for various forms of forward-looking data. The empirical findings are then presented through summaries of auditors' experiences with forward-looking data, their opinions regarding their future role in forecasting, and their attitudes concerning the problems inherent in increased public disclosures.

BACKGROUND OF THE FORECASTING ISSUE

Since February of 1973, when the Securities Exchange Commission (S.E.C.) abandoned its long-standing position prohibiting forecasts from inclusion in filings with the Commission, the accounting profession's involvement and interest in the forecasting area has increased substantially. A number of AICPA groups have since studied the issues related to preparing, reporting, and reviewing financial forecasts and projects. In the accounting literature, controversies developed over whether or not independent accountants could, would, or should be included in the forecasting process, and if so, what role professional standards should play.

The general tenor of the S.E.C. regarding forecasting has changed somewhat since 1973. In its early pronouncements on forecasting guidelines and requirements, the S.E.C. seemed to be most concerned that companies wishing to issue a public forecast make the forecast available to all interested parties at the same point in time so that no one individual or group had access to the

forecast data before any other interested parties.[1] Part of the S.E.C.'s concern resulted from investor complaints that such forecasts were being selectively disseminated to individuals (such as security analysts or investors with large equity holdings) who were using the "inside information" as a basis for trading. Trading based on inside forecast information thus conflicted with the philosophy of the S.E.C., and its reactions were aimed at addressing the problem of "insider" forecast information.

In 1975, the S.E.C. proposed a guideline which would have required publicly traded companies to file with the commission on a form 8-K any forecast prepared for public release within ten days of its preparation.[2] In response to the proposed guideline, the S.E.C. received more than 400 letters, most of which opposed the new reporting guide. After a number of postponements in the hearing deadline period, the S.E.C. withdrew its proposal in the belief that, rather than complying with the proposed guideline, companies would stop issuing projections altogether.

Beginning with the S.E.C. Advisory Committee on Corporate Disclosure report issued late in 1977, the S.E.C.'s position moved toward encouraging companies to forecast and to provide "soft" forward-looking data to shareholders. The changes that have been made in S.E.C. guidelines since 1977 have taken a more liberal stand on requirements for making public forecasts of financial information. In addition, in June of 1979, the S.E.C. issued its safe harbor rules for financial forecasts which became effective July 30, 1979.[3] The final safe harbor rules, which place the burden of proof on the plaintiff, are the most liberal thus far proposed by the S.E.C., and are clearly aimed at encouraging forecasting by providing liability protection to both companies and third-party reviewers of qualified financial forecasts. As a case in point, while the

safe harbor rules encourage the inclusion of any key underlying assumptions, their inclusion is not a requirement for protection under the safe harbor rules.

The AICPA has pursued the question of the auditor's role in financial forecasting persistently since 1973. In 1975, the MAS Forecasting Task Force published ten formal guidelines for preparing a financial forecast, and the Accounting Standards Division issued a Statement of Position on its forecasting guidelines.[4] Both of these 1975 documents have been partly subsumed in the audit guide entitled: "Review of a Financial Forecast," which was issued in the form of an exposure draft by the Auditing Standards Board in November 1979. The guide discusses how auditors might evaluate financial forecasts of management and what types of reports might be issued by auditors regarding the forecasts. It would appear that the auditor is headed for a more active role in the area of financial forecasts.

FORWARD-LOOKING DATA--PROBLEMS OF TERMINOLOGY

There are a number of different forms which forward-looking financial information might take, and there are also a number of different terms used in conjunction with these various forms of data. The forward-looking data which will be discussed here relate principally to statements of financial results and positions which are constructed on an expectational rather than a historical basis.

The AICPA, in its past pronouncements on the subject, has distinguished between budgets, forecasts, and projection. Budgets are forward-looking documents which are viewed as being used primarily for motivation and control purposes, while forecasts represent what management believes to be the "most likely outcome" and are, therefore, not necessarily the same as budgets. Projections, as defined by the AICPA, are financial estimates which are based on assumptions that

may not necessarily represent the most likely outcome. Projections may be made on the basis of "what if" statements and related assumptions, rather than assumptions based on the most likely outcome.

The S.E.C. has been much less precise in its definitions than has the AICPA. At one point, the S.E.C. considered requiring that three years of budget information be reviewed in comparison to actual outcome in order to permit a company to qualify for safe harbor. Such a position suggests equation of budgets and forecasts. Also, in much of the S.E.C. material the terms projections or projections and other forward-looking information are used to describe data which would apparently fall under the AICPA's definition of a forecast.

In our discussions with a number of financial planning executives, it was apparent that they too had conflicting definitions for these terms. On the one hand, some indicated no difference between budgets and forecasts (using the AICPA definition of "forecasts"), while others said that budgets were not the same as forecasts. While there were virtually no cases of corporate officials using the term projections per AICPA terminology, one person indicated that his company did adjust what it considered to be its most likely profit forecast whenever it was given to an outside party, and that the size of the downward adjustment depended on who was going to receive the profit forecast.

The statements of the AICPA and the S.E.C. vary with regard to the contemplated content of a forecast, with the S.E.C. having more flexible guidelines as to what needs to be or may be included. The AICPA initially suggested full financial statement format. On the other hand, the S.E.C. permits isolated financial data, including data normally not reported in financial statements, such as capital expenditure forecasts, financing and capital structure forecasts, dividend forecasts, and statements regarding management's plans and

objectives for future operations. In the recent audit guide mentioned previously, the AICPA's Auditing Standards Board has moved toward acceptance of summary income statement data as a minimum level of forecast disclosure.

Definitions to be Used in This Paper

In order to facilitate discussion, the following definitions are adopted in the remainder of this paper. Examples of actual practice for each type of financial analysis are also provided.

Budgets: operating plans for specific areas such as sales, production, capital budgeting, and research, among others. An example is the beginning-of-a-period document which communicates the various costs per equivalent unit for a manufacturing cost center. The budget data are compared to the actual operating results each month or quarter, and variances from the budget are explained and investigated. The term of the budget is typically one year.

Forecasts: estimates of the most probable financial position, results of operations, or change in financial position for an entity which takes the form of a full or summarized financial statement. If, on December 31 of year 1, management constructs what they believe to be the most likely income statement which will result from year 2 operations, that income statement is termed a forecast.

Projections: estimates of financial results based on assumptions which do not necessarily represent the most likely outcome, such as "what if" types of financial statements. If, on December 31 of year 1, management constructs an income

statement which they believe would result from year 2 operations if a particular segment were discontinued, and if that discontinuance has a rather low probability, then the income statement is an example of a projection.

Feasibility Studies: analyses of proposed courses of action which may or may not include forecasts or projections. A hospital feasibility study may include budgets, projections, and forecasts. A capital expenditure feasibility study may be merely a return-on-investment analysis which does not include any of these.

Forward-Looking Data: We use this term as a general category which includes as specific subcomponents budgets, forecasts, projections, and feasibility studies.

For the most part, these definitions conform to the definitions proposed by the AICPA in their recent exposure draft.

RESULTS OF INTERVIEWS

Demographics of Participants

A total of forty-two auditors participated in the study. Nine large firms were asked to participate and all provided the requested personnel. It was explicitly stated in the request for cooperation that prior forecasting experience was not required of participants. The average public accounting experience of the participants was 13.8 years. The twenty-eight audit partners had been partners for an average of 5.8 years, and the fourteen audit managers had been in that position for an average of 4.6 years. Of the forty-two auditors, seven (17 percent) indicated they had spent some time in either the tax staff or the management services staff of their firms before coming to the audit staff.

Only six (14 percent) had non-CPA firm experience prior to their current audit staff positions. A number of the auditors served in some technical executive capacity, including overall responsibility within the office or region for professional standards, S.E.C. reporting, mergers and acquisitions, and final engagement review. The information listed in Table 1 summarizes the specialties of the auditors, each of whom generally had more than one area of special expertise (average = 1.7 areas).

TABLE 1

Summary of Areas of Special Expertise

Area	Frequency with Which Area Was Cited
Manufacturing	19
Banking/Financial	8
Nonprofit/Governmental	7
Retailing	7
Small Business	6
Health Care	5
S.E.C.	3
Agriculture	2
Transportation	2
Education	2
Insurance	2
Real Estate Development	2
Brokerage	1
Leasing	1
Wholesale	1
Utilities	1
Computers	1
Petroleum	1
Railroads	1
	72

Research Techniques

Each participant was interviewed by means of an open-ended questioning technique which involved asking standard questions in a consistent order. The participant was allowed to answer each question fully and freely. After the

volunteered response ended, standard probe questions were asked if, in the judgment of the interviewers, the topics had not been covered in the original response. The interviewers used two coding documents. One was filled out during the original interview and the second upon listening to the complete tape recording of the interview. The documents were then reconciled and any ambiguities were settled by having another researcher recode the applicable portion of the taped interviews. The interviews averaged seventy minutes in length, ranging from a minimum of forty-five to a maximum of ninety-five minutes.

Incidence of Formal Budgets and Forecasts among Audit Clients

In order to gain an understanding of the experience auditors have had with the forward-looking data of their clients, we asked each participant to estimate what percentage of their current clients prepared formal budgets and formal forecasts. We defined formal as those forward-looking data which were systematically prepared and in written form. Figures 1 and 2 summarize the results broken down by publicly traded and private held clients.

In general, as can be seen in Figures 1 and 2, slightly more clients prepare formal budgets than formal forecasts. In addition, publicly traded clients prepare formal budgets and forecasts to a far greater extent than do privately held clients. Only a very small percentage of the participants indicated that none of their clients prepared budgets and forecasts. These results suggest that the vast majority of audited companies prepare formal budgets and forecasts for internal use.

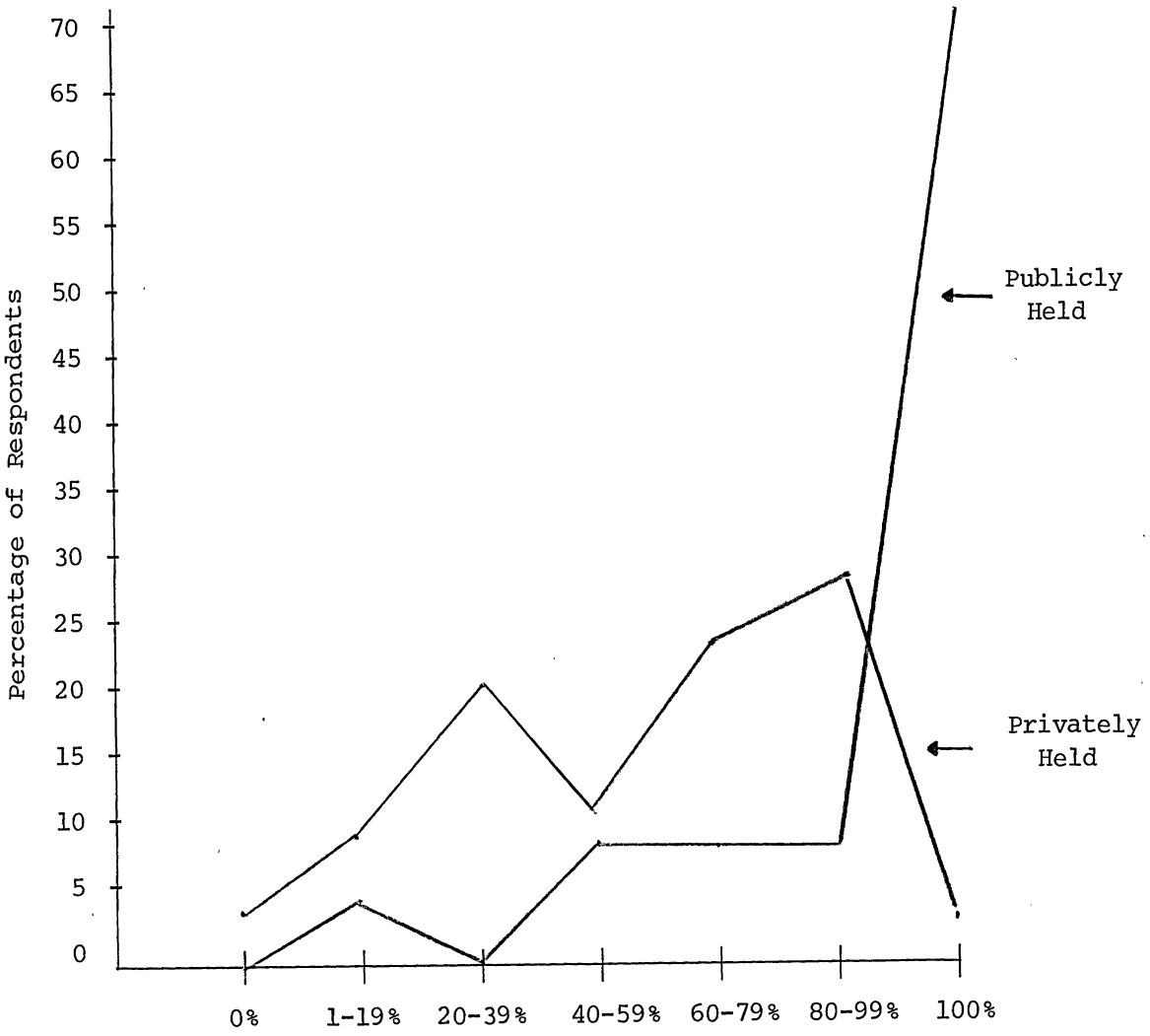

Figure 1. Estimated Percentage of Clients which Prepare Formal Budgets.

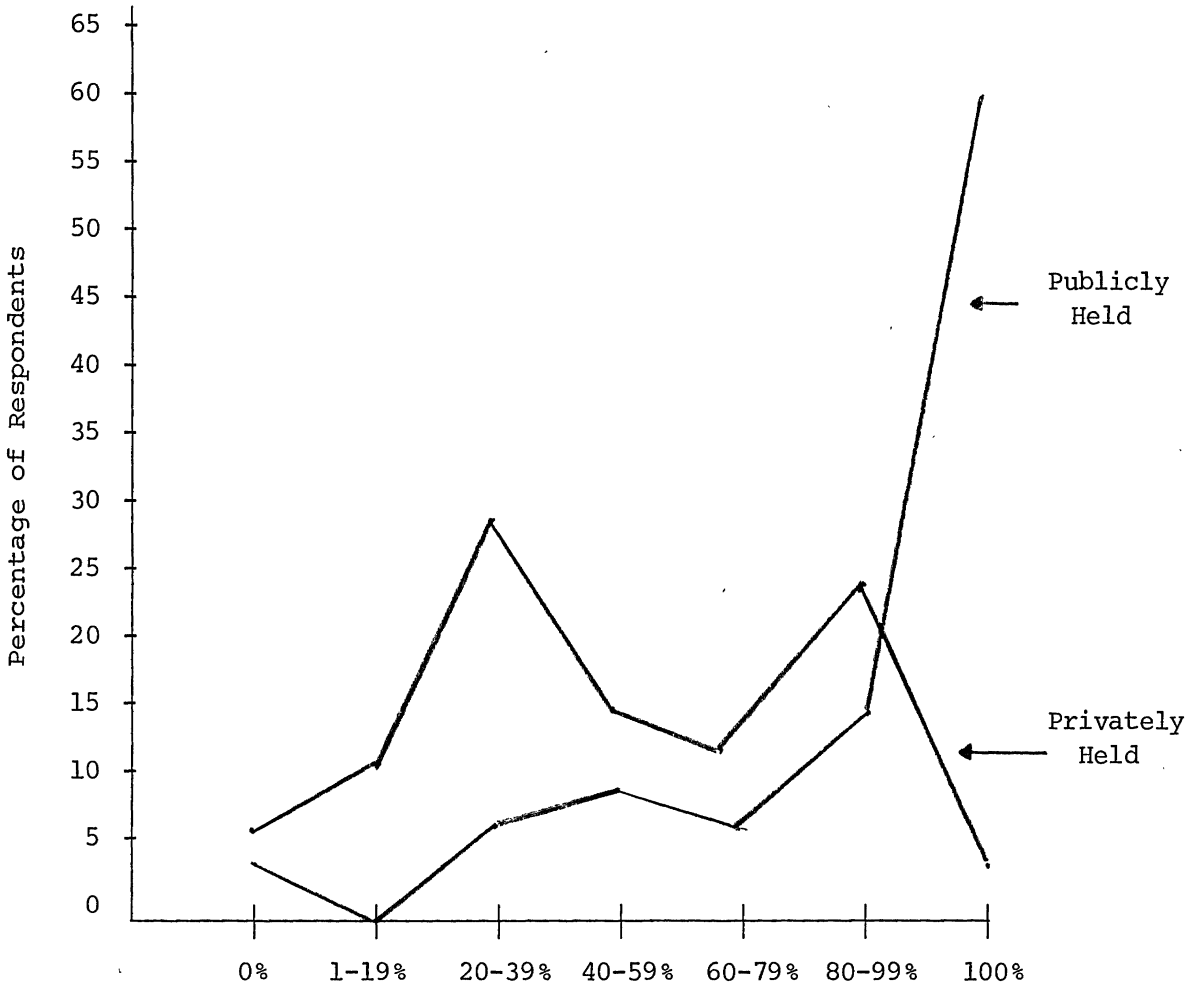

Figure 2. Estimated Percentage of Clients which Prepare Formal Forecasts.

The Use of Forward-Looking Data in Auditing

Once the incidence of formal budget and forecast preparation among audit clients was determined, an attempt was made to ascertain the nature of the auditors' involvement with their clients' forward-looking data. The following analysis is divided into: 1) use of forward-looking data in the auditing process and 2) use of forward-looking data in nonauditing services.

Only one respondent stated that forward-looking data were not used in auditing. That subject also indicated that only a small percentage of his clients prepared budgets and none prepared forecasts. All other subjects indicated that forward-looking data were used in the auditing process, with the following incidences of use:

Characterization of Use in Auditing	% of Respondents
Used Rarely	8%
Used Occasionally	27%
Used Whenever Available	65%
	100%

In a majority of cases the forward-looking data described were in the form of a projected income statement or another component of the client's budget. Of those auditors who used budgetary data only part of the time, the principal factor considered was how well the system worked. When budgets were not felt to be effective, they were not used in the audit process.

The specific audit steps in which forward-looking data were used by respondents were:

Audit Steps	% of Respondents
Analytical Review	76%
Planning of Audits	41%
Quarterly Statement Review	30%
General Background Information Only	14%

In open-ended discussions of the use of forward-looking data in auditing, the following specific uses were mentioned in addition to those listed above: 1) internal control evaluation, 2) going-concern problems, 3) meetings with boards of directors and trustees, 4) loan covenant problems, 5) subsequent events review, 6) inventory level analyses, and 7) closing conferences with management.

Variances and variance analysis were mentioned by most of the participants as key elements in the evaluation of budget data. A number of auditors stated that the explanation of variances was closely examined and followed from period to period to help identify unusual or unexpected behavior which was felt to be important indicators to auditors. Several auditors indicated that they

actually participated to some extent in identifying the cause of some variances, either with the clients' managers or independent of the managers or both.

In addition, those auditors having certain nonprofit clients indicated that budgets were usually part of their financial reports and, therefore, the audit programs in such cases always included detailed analyses of budgeting data. Also, auditors involved in quarterly statement reviews pointed out that SAS 24 required the review of budgeting data.

Based on this sample, it would appear that most audit clients have some formal forward-looking data and that such data are often used in the auditing process.

The Use of Forward-Looking Data in Nonaudit Services

Auditors are sometimes called upon to analyze, discuss, and/or construct projections and feasibility studies for clients. Each participant was questioned about her or his involvement with such forward-looking data as well as any involvement with forward-looking data which was communicated to parties outside of the client entity. The goals here were to determine what, if any, associations auditors have had with clients' forward-looking data outside of the normal auditing context, and if those associations would be in any way analogous to the public association of a third-party reviewer.

Table 2 provides a summary of the auditors' experiences with forward-looking data in a nonauditing context, broken down into the three general user groups who received the data.[5]

TABLE 2

Summary of Auditor Involvement with
Forward-Looking Data in Nonaudit Services

Recipient of Forward-Looking Data		Type of Data	Percentage of Subjects	Range of Frequency of Involvement for Each Subject
A. Governmental Agencies	1)	None	61%	
	2)	Hospital Feasibility		
		Direct Involvement	13%	1 to 8
		Review Only	13%	1 to > 20
		Total	26%	
	3)	Tax Shelter Analyses	13%	1 to > 20
B. Other Outside Entities	1)	None	11%	
	2)	Creditors		
		Formal Analyses	55%	1 to > 20
		Discussions Only	24%	1
		Total	79%	
C. Internal Management	1)	Merger Analyses		
		Formal	34%	1 to > 20
		Discussions Only	21%	1 to > 20
		Total	55%	
	2)	Capital Expenditure Analyses		
		Formal	18%	1 to 6
		Discussions Only	29%	1 to 10
		Total	47%	
	3)	Troubled Company Analyses	36%	1 to 2
	4)	Tax Planning	14%	1

Other forms of involvement with communication of forward-looking data to governmental agencies which were mentioned but not included in the table due to their low frequency were Small Business Administration loan applications, securities registrations with the S.E.C., municipal stadium feasibility studies, and federal government grant applications.

All of those questioned mentioned the fact that their experiences with hospital feasibility studies were not necessarily indicative of their firm's experience. It was pointed out that their management advisory services group tended to be more heavily involved than the auditing group in such cases. The hospital feasibility studies represented the most complete form of forecasts with which auditors have been involved. It is also the area where auditors seem to have been most willing to issue a report in conjunction with forward-looking data. These feasibility studies typically include an attestation as to the reasonableness of the forecast and the underlying assumptions. Such studies are extremely detailed, in contrast to most other forms of forward-looking data encountered, and include a great deal of nonfinancial data which are used as a basis for the financial forecasts. It may be important to note that these hospital feasibility studies are much more elaborate than the type of forecasts necessary to meet current S.E.C. and proposed AICPA guidelines, and they do receive an auditor's opinion as to the reasonableness of the forecast and the underlying assumptions.

Table 2 also lists the forward-looking data reported to nongovernmental entities with which auditors had been associated. The majority of auditors had some experience with forecasts prepared in conjunction with credit-granting institutions. In addition, other types of involvement with clients' forward-looking data communicated to outside entities which were infrequently mentioned were:

1) analyses sent to underwriters, 2) analyses sent to bond rating institutions, 3) analyses sent to a health insurance company for a health care client, and 4) analyses of accounts receivable valuation for clients' banks. Apparently it is not unusual for security underwriters to receive forecast information from clients entering the security markets. Also, when there is some reason to believe that a company's bond rating may be changed, the rating agency will frequently request such forward-looking data to support or reject a possible change in grade. Most forecasts for external use were income statement oriented, with cash or working capital information also frequently provided.

Clearly the most common form of auditor involvement with the forecast information of clients was in the area of creditor evaluations of the clients' creditworthiness. Some companies are apparently asked to provide lending institutions with forecasted income and cash flow data as a condition of maintaining a given line of credit. More often, forecasts were used to assist clients in expanding credit or in changing lending institutions. Auditors indicated that, for the most part, such forecasts were based on the budget systems when available. However, they indicated that clients' forward-looking data given to lending institutions tended to be on the conservative side and usually represented a more achievable target than budgeted profit. For example, auditors observed that it was not uncommon for such forward-looking data to have been based on the budget, but with anticipated unfavorable budget variances being built in to the forecast.

In the "internal use" category, the most common type of forward-looking data which auditors were involved with were those related to merger analysis, with over half of the auditors having some involvement. A number of auditors indicated active involvement in preparing forecasts of income and cash flow for companies to be acquired by clients. Such cases usually occurred when the company

being acquired was a willing party to the acquisition. These forecasts were generally for longer than one year, often five or six years into the future. However, forecasts for the coming year or six months were frequently used as a basis for the final purchase price.

Capital expenditures were also mentioned by auditors as an area where they sometimes became involved with forward-looking data preparation. This activity focused on the cash and income flow effect of the new assets. The involvement here tended to be more with costs than with revenues and external factors, which are probably of equal or greater importance in capital budgeting. In later questions which explored the overall forecasting process, auditors indicated general agreement that the prediction of revenues was both the most pivotal and the most difficult aspect of the forecasting process. This probably explains the low frequency of auditor involvement with the revenue side of capital budgeting.

One area which was particulary interesting was auditor involvement in the analysis of a troubled company. This activity was initiated by the auditor to help evaluate the reasonableness of the going-concern assumption which is necessary to issue an unqualified opinion. These situations were farily common, with 36 percent of the auditors mentioning their involvement with forward-looking data regarding questions of the going-concern assumption.

Tax planning for smaller clients was also mentioned as an area where auditors have become involved to some degree with forward-looking data. The purpose of this forecast activity was to facilitate minimization of tax payments. Other types of situations mentioned where forward-looking data were prepared included sale and leaseback transactions and the sale of a discontinued operation.

From the above data it is concluded that virtually all of the auditors have had some experience with forward-looking data outside of the auditing realm. A rather small percentage of the auditors have been involved with forward-looking data as a part of communications to governmental agencies, while a much larger proportion of the auditors indicated that they had been involved with forward-looking data for use by creditors of clients. In general, the participants were much more involved in cases where forward-looking data were used by management than in cases where data were directed to outside parties.

AUDITOR ATTITUDES CONCERNING CLIENT FORECASTS

The experiences of auditors with clients' forward-looking data provide useful input to the evaluation of the auditor's past, present, and future role in the preparation and review of such data. A number of questions which elicited auditors' opinions regarding various aspects of forecasting were asked. The auditors were informed that these questions were seeking their subjective opinions only without concern for their firm's official policies regarding forecasting.

The first question concerned their overall feelings as to the desirability of publicly disclosed financial forecasts. A number of participants hedged on this question and did not answer it at first. However, all eventually indicated a position for or against, as summarized in Table 3.[6]

TABLE 3

Summary of Attitudes toward Public Forecasts

Attitude	Number of Auditors	Percent
Strongly In Favor	6	14%
In Favor	15	36%
Not In Favor	12	29%
Strongly Not In Favor	9	21%
	42	100%

The results are mixed, suggesting that auditors are definitely not in agreement as to whether forecasts should be made public. Exactly 50 percent were in favor and 50 percent were against public forecast disclosure. Both sides expressed many reasons in support of their positions. On the positive side, most simply indicated that forecasts would be very useful to outside investors and creditors in making decisions by reducing future uncertainties. A few took the strong position that historical data are of no value to decision makers and that forecasts and projections are the most relevant types of information for outside parties. Several auditors also mentioned that since forward-looking data were currently being prepared anyway, publicizing them might reduce the problems associated with the selective dissemination of forward-looking data to outside parties.

Regardless of his or her overall opinion, each participant was asked to identify the major problems with public forecasts. Their responses, summarized in Table 4, included a number of interesting and insightful comments. The most frequently cited concern was the misuse of public forecasts by outside parties. Many auditors mentioned that including forecasts in financial reports

TABLE 4

Major Concerns Regarding Public Forecasts

Concern	Frequency
Misuse or Misunderstanding by Users	21
Client Liability	12
Auditor Liability	8
Management Expertise in Forecasting	7
Pressure on Management ot Manipulate/Achieve	7
Method for Facilitating/Requiring Updates	5
Managements Perceived Responsibility Without Control	5
Auditors Inability to Test Reasonableness	3
Managements Tendency Toward Conservative Forecasts	3
Management Taking Over Investors' Responsibilities	2
No Information Value by the Time Forecast is Published	1

along with the actual historical outcomes might lead some report users to infer more certainty than warranted. It was also mentioned by some that the misuse or misunderstanding which could result from such public forecasts might lead outside users to become dissatisfied or unduly critical of the overall financial reporting process. Such concerns seem to be based on the implicit assumption that user unhappiness with financial forecasts would also result in unhappiness with other financial data. On the surface, the claims of misuse suggest an overall lack of confidence on the part of the participants that users of financial data would evaluate financial forecasts in a proper perspective.

Client exposure to liability and auditor exposure to liability were the second and third most frequently cited concerns, respectively. Although the S.E.C.'s safe harbor rules are intended to significantly reduce the legal liability exposure for both the management issuing the forecast and the third-party reviewers, auditors remained apprehensive of the legal implications. The concern over how to update or revise forecasts is related to the safe harbor rules in that new information which might materially alter earlier forecasts (in either a favorable or an unfavorable way) must be promptly disclosed to maintain the protection of the safe harbor. While the safe harbor rules are quite broad in their protection of forecasters and forecast reviewers, they do not completely eliminate the possibility of legal action. Our findings suggest that auditors still consider liability exposure to be a major concern.

A number of auditors also expressed their concern that once a public forecast were issued management would feel some pressure to achieve their target. The possible manipulation of financial statement data was mentioned as having two negative side effects: 1) short-run adjustments to the economic activities of the firm (e.g., cutting back on maintenance, advertising, etc.) to achieve the current forecast, with detrimental effects on long-range performance; and

2) distortion of the relationship between the information being forecasted (operating income, net income, E.P.S., etc.) and variables of interest to outside users (e.g., long-run cash-generating ability of company, market value of company, growth potential of company, etc.), with a resultant decline in the interest in both the financial forecasts and the "actual" financial outcomes. This latter point seems to be a very valid concern, and might explain why so many auditors felt that the misuse and misunderstanding of forecast data might also lead to the demise of the historical financial statements.

Related to the belief that managements would feel some pressure to meet their published forecasts were the auditors' concerns over management's ability to forecast and control all aspects of activity necessary to achieve their target. These concerns seem interrelated in that both are based on doubts about the capacity of any forecaster to predict accurately. In connection with these two concerns, a number of auditors cited such events as the energy crisis, sugar and coffee shortages, and other markets which have seen radical fluctuation in recent years as examples of unpredictable and uncontrollable factors which create problems for even the most sophisticated financial planning process.

One other concern reflected doubts about the information value of published financial forecasts. Recall that the S.E.C. was initially concerned with making forecasts available to outside users on an equal and timely basis. One auditor expressed the concern that this would never be achieved, in that selective early dissemination of important new information would always take place. As a result, by the time the forecasts were publicly available, the data they contained would no longer be new; on the contrary, the information content of such forecasts would be fully reflected in the market price of a company's stock before the forecast data were officially reported to the public. While only one of the participants expressed this concern, timeliness is an important point which should be taken into account in evaluating forecast policy decisions.

The format of published financial forecasts was mentioned in the beginning of the paper as a point about which the S.E.C. and AICPA were not yet in complete agreement, with the S.E.C. requiring less data than the AICPA. Table 5 summarizes the responses regarding the auditors' preferences for the formats of forecast data.

TABLE 5

Format Preferences for Management Forecasts

Form of Forecast	Frequency Cited
Bits and Pieces of Financial Data	18
Income Statement Summary Data	14
Key Forecast Assumptions	8
Balance Sheet Data	4
Full Income Statement Data	2
Funds Statement Data	2
Full Financial Statements	1
Company's Objectives	1

The majority indicated a preference for summarized or selective information as opposed to full financial statements. In general, auditors felt that if forecasts were going to be made public, only summarized elements of key financial data should be reported in order to minimize the amount of information which might be useful to competitors and to minimize problems or misuse of outside parties. In addition, it was felt that forecasts should be clearly segregated from historical statements.

Regardless of their preferences with respect to format, all auditors were asked to identify which items they would like to have forecasted if they could receive only a few bits of forecast information. Their responses, summarized in Table 6, suggest that sales and income measures are perceived to be the most important elements of forecast data.

TABLE 6

Preferred Elements of Forecast Information

Forecast Data	Frequency Mentioned In Total	First	Second
Sales	26	18	5
Net Income	24	5	16
E.P.S.	14	7	7
Cash Flow	12	4	6
Capital Expenditures	10	0	3
Market Share	7	2	0
Gross Profit	5	1	3
Major Assumptions	5	2	1
R.O.I.	4	0	0
Volume of Activity	4	3	1
Balance Sheet Data	4	0	0
Full Financial Statements	1	0	0
		42	42

Income statement data dominates the list of data items, with forecasted cash flow, capital expenditure plans, and expected market share also mentioned frequently. Sales was mentioned first most frequently, more often than net income, earnings per share, and gross profit combined. Segment information was mentioned six times in conjunction with some types of data (e.g., sales by segment and income by segment). Some mentioned that the aggregated financial data of a multi-product, multi-industry company would not be useful unless it were somehow segmented.

Auditors were asked to state whether or not, given the state of the art in forecasting, they felt that managements were capable of forecasting with a reasonable degree of accuracy. As summarized in Table 7, 57 percent of the auditors felt management was capable of forecasting reasonably well. Only a few auditors (14 percent) said that management could not forecast with reasonable precision, while 29 percent said that they were uncertain. In the uncertain category, a number of factors which affect management's ability to predict were

TABLE 7

Perceived Management Forecast Ability

Can Management Forecast?	Response Frequency
Yes	24
No	6
Uncertain	12
	42

mentioned. The size of the company and the sophistaction of its financial planning system, the stability of a company and its market position in the industry, the general state of the economy, and the number of externalities which might significantly affect a forecast but which are beyond the control of management were all mentioned as important.

The answers to the question of management's ability to forecast were of particular interest. While some evidence exists on the accuracy of management forecasts for companies which have chosen to publish their forecasts of earnings in the financial press, the evidence suggests that this group of willing forecasters might not be representative of their nonforecasting counterparts.[7] The auditors' judgments are based on broad experience with budgets and forecasts which are not made public. As a result, the judgments regarding management's forecast capability provide some important insight into what might be expected from companies which have not previously made their financial forecasts available to the public. In order to clarify what is meant by "reasonable" accuracy, each participant was asked to identify what they felt to be a reasonable percentage error for a financial forecast. Most participants set 20 percent as the upper limit for a reasonable error. On the basis of the combination of answers received, it may be concluded that a majority of the auditors felt management could forecast within 20 percent of actual earnings. It is also noted that only 15 percent

of the respondents mentioned management's ability to forecast accurately as a major concern.

The auditors were asked to express an opinion as to why management might be interested in initiating public forecasts. As indicated in Table 8, the most commonly volunteered reason was management's perceived desire to influence the market price of their company's stock.

TABLE 8

Management's Perceived Motivation in Forecasting

Reason Cited	Voluntarily	After Probe
Influence Market Price	17	8
Public Relations	7	1
Communicate with Analysts	6	4
Public Responsibility	5	0
Peer Competition	4	10
Management Confidence	3	0
Management Compensation	3	0
To Facilitate Obtaining Capital	3	0
For Internal Benefit	2	1
Labor Negotiations	1	0

Many auditors felt that management might feel pressure to announce only good news. The general thrust of most of the reasons cited was to make users of financial data aware that the expectation for the future was positive. This is consistent with the results of a previous study of 131 observations of management's public forecasts of earnings. In that study, all earnings forecasts except for those in regulated industries predicted increases in earnings.[8]

Some peripheral reasons for issuing public forecasts were also noted. Some auditors indicated management might feel a responsibility to provide forecast data, since most corporations do currently make some mention of the future in their annual reports. For example:

> Almost half of our total corporate sales are to the automotive aftermarket and we expect to increase our volume by about 15 percent in 1979.[9]

and

> An integral component of the five-year plan, which targets $1.15 billion in sales by 1982, is an acquisition program to bring in $150 million in additional sales....[10]

Such volunteered statements could be based on a feeling of responsibility to provide forward-looking information to shareholders.

The most mixed reaction occurred in responsed to the notion that management might make forecasts public in response to peer pressure or peer competition. A few auditors mentioned this point, and a number of them accepted it as a possible motivating factor once it was suggested. However, most auditors, when probed on this point, suggest that if competitors were issuing forecasts it would be a good reason for management not to forecast. The implication was that forecasts could be useful to competitors, hence forecasting could become a competitive disadvantage.

The two final opinions elicited concerned the relationship between corporate management and security analysts. First, auditors were asked if security analysts could forecast as well as management. The vast majority (71 percent) felt that analysts could no do as well as management, while 10 percent said analysts could do as well and 19 percent were undecided. It was strongly felt that since management had the most detailed and complete information concerning the company, they would be able to outpredict analysts. One auditor, who fell into the undecided group, mentioned that while management had more information than analysts, they were also more biased in their use of such information in forecasting.

Finally, the subjects were asked if they felt analysts were independent of management in the forecasting process. Most auditors (57 percent) felt

analysts were not independent and that they received information from management as a basis for their own forecasts. While a large percentage of respondents were uncertain about this question (40 percent), it is significant that only one auditor felt analysts' forecasts to be independent of management information. Discussions with a number of corporate executives involved in the financial planning process confirmed this belief. Corporate planning executives acknowledged that analysts often requested forward-looking information, and some companies have identified a separate external forecast communications person to deal with all such requests.

SUMMARY AND CONCLUSION

Based on the results of this study, it appears that auditors are somewhat familiar with their clients' forward-looking data. Auditors routinely use budget data in their audit procedures; 76 percent indicated that they used budgets in the analytical review process alone. In addition, a number of other uses of forward-looking data were identified in an auditing context.

Auditors also identified other instances of involvement with forecasts and projections of their clients. Hospital feasibility studies were the principle source of auditor experience with formal publicly disseminated forecasts which called for auditors' opinions as to reasonableness.

A number of other situations were identified where the auditor had a less formal association with clients' forecasts. For example, of 75 percent of the auditors had some contact with forecasts. For example, of 75 percent of the auditors had some contact with forecasts prepared for outside credit-granting institutions. The overall results from the analysis of auditor involvement suggest that auditors have had substantial exposure to the forward-looking data of clients both within and outside of the audit context.

The final section of the paper evaluated the attitudes of auditors regarding forecasting issues. Auditors were evenly split as to whether or not they favored public disclosure of managements' financial forecasts. Their major concerns involved the misuse and misunderstanding of forecast information on the part of financial forecast users, and the additional liability exposure for both management and auditor (as a third-party reviewer). Assuming forecasts were to be made public, auditors generally felt that select income statement data should be forecasted, with sales and net income identified as the most useful information. Most auditors felt, given the state of the art in forecasting, that management could forecast their own financial data better than security analysts, and that they might be more likely to voluntarily provide such forecasts if they had good news to communicate which might positively influence the image of their company and the market price of its securities. On the basis of these forty-two interviews, the consensus among auditors seems to be that the profession, in addressing the question of the auditor's role in public financial forecasts, should proceed with caution.

The research results discussed above signal a need for additional research into how the auditor could contribute to the forecasting process. Auditors are unique in the breadth of their experience with forward-looking data of clients. However, the inconsistency in their attitudes concerning forecast issues leads to questions about their willingness and ability to make positive contributions to the public reporting of forecasts. Research into how auditors would address the forecast review and attestation process is needed. It would be interesting to know if their attitudinal differences carried over to the actual evaluation process.

Given the current pressures toward forecasting, we may well be on the threshold of a new frontier in auditing. Investigations into the auditors' role in financial forecasts have just begun to become significant to the profession. Future work in this area seems imperative.

NOTES

1. Securities and Exchange Commission, "Statement by the Commission on the Disclosure of Projections of Future Economic Performance," Release No. 5362 (Securities Act of 1933), Release No. 9984 (Securities Act of 1934) (Washington D.C.: S.E.C., February 2, 1973).

2. Securities and Exchange Commission, Release No. 5581 (Securities Act of 1933), Release No. 11374 (Securities Act of 1934)(Washington D.C.: S.E.C., April 28, 1975).

3. Securities and Exchange Commission, Release No. 6084 (Securities Act 1933), Release No. 15944 (Securities Act of 1934)(Washington D.C.: S.E.C., June 25, 1979).

4. American Institute of Certified Public Accountants, Exposure Draft: Proposed Guide, Review of Financial Forecasts (November 23, 1979.

5. As expected, we found a statistically significant relationship between experience in public accounting and amount of exposure to forward-looking data of clients in a nonauditing context (i.e, the null that there was no relationship rejected at the $\alpha = .10$ level).

6. Tests of association failed to reject the null hypotheses that there were no significant relationships between attitude and 1) years of experience, 2) amount of experience with forward-looking data, or 3) nature of experience with different types of forward-looking data.

7. Imhoff, E. A., "The Representativeness of Management Earnings Forecasts," The Accounting Review (October 1978), pp. 836-850.

8. Ibid.

9. Sealed Power, 1978 Annual Report.

10. Harsco Corporation, 1978 Annual Report.