Part II: General application guidance

Part II includes illustrative procedures for preparing PFI, and any supporting PFI, in accordance with the PFI principles.

Part II: General application guidance

1. INTRODUCTION

1. This part identifies procedures that will assist in the preparation of PFI that is relevant, reliable, understandable and comparable, and therefore will be useful to the user of the PFI.

2. PFI is prepared for a variety of purposes and in a number of contexts, including to support merger and acquisition (M&A) activity and the raising of equity and debt finance.

3. The term 'preparer' means the person or persons with ultimate responsibility for the PFI, as well as such other persons or parties who they have directed or instructed to assist with the preparation of the PFI. For corporate entities, the directors would typically be expected (or required by regulation) to have ultimate responsibility for any PFI that is published or otherwise made available to an external party. Also, the term PFI means prospective financial information prepared for internal purposes and that for publication or for disclosure to external users, as well as any underlying/supporting financial forecasts, projections or financial forecast model (referred to in this Part as 'supporting PFI').

4. When preparing a financial forecast model, consideration might also be given to relevant elements of:
   - the ICAEW Spreadsheet Competency Framework, which provides a framework for assessing a person or party's modelling skills[8];
   - the ICAEW Corporate Finance Faculty's best-practice guideline, Financial Modelling[9];
   - the ICAEW Tech Faculty's Financial Modelling Code, and Twenty principles for good spreadsheet practice[10]; and
   - ICAEW resources on technology and finance[11].

2. ILLUSTRATIVE PROCEDURES FOR PREPARING PFI

5. The preparation of PFI should be carefully planned, executed and documented. The practical considerations set out in the table below are categorised under these stages.

6. While the purpose and context of the PFI may differ, the preparation of PFI generally requires a wide range of business skills and commercial judgement as well as accounting expertise, and certain core processes and procedures are typically appropriate.

2.1 Illustrative practical considerations and techniques for preparing PFI and supporting PFI

7. The list below is not exhaustive or prescriptive; other considerations and techniques may be applicable. The preparer should assess those that are likely to be relevant having regard to the purpose and context of the PFI, the size, complexity and circumstances of the entity or group, the industry, and the general economic environment.

[8] icaew.com/technical/technology/excel/spreadsheet-competency-framework
[9] icaew.com/technical/corporate-finance/corporate-finance-faculty/guidelines
[10] icaew.com/technical/thought-leadership/tech-faculty/thought-leadership-excel
[11] icaew.com/technical/technology

PLANNING

Purpose of PFI

a. The preparer should identify the purpose for which the PFI is being prepared and the appropriate period to be covered to ensure the form and content of the PFI meets the known or anticipated needs of its users.

Applicable regulation

b. The preparer should understand any applicable legal and regulatory requirements of the proposed PFI and its use, issue or publication. Consideration should also be given to industry-specific regulatory requirements that may impact plans and performance and, hence, the PFI, for example regulatory capital requirements that apply to certain financial institutions.

Business analysis and strategic plan

c. The preparer should identify whether appropriate up-to-date business analysis and a strategic plan exist upon which the PFI should be based.

d. If business analysis and a strategic plan need to be updated or developed, the preparer should determine who needs to be involved in this process.

e. Financial constraints such as banking agreements and covenants that may impact the plans and performance (and hence need to be reflected within the PFI) should be identified and the implications considered.

Financial forecast model and level of detail

f. The preparer should establish whether the business already has a suitable financial forecast model to generate the PFI. If no suitable model exists, the preparer should determine who will be responsible for developing a model and whether that person or party has appropriate financial modelling skills.

g. The preparer should determine the level of detail required in the PFI and ensure that the financial forecast model has the functionality to deliver the required level of detail. For example, integrated income statements, cash flows and balance sheets on a monthly basis are normally required – but depending on purpose, circumstances, materiality, seasonality and the nature of the businesses, different interval periods may be appropriate.

h. The preparer should determine what quality assurance procedures should be applied to the financial forecast model, which may include independent testing procedures on the model. The extent and form of testing to be undertaken should be considered in the context of the complexity of the model and the ultimate purpose of the PFI.

Involvement of directors and managers

i. Directors (or equivalents in unincorporated businesses) and other appropriate senior members of financial and operational management with the necessary in-depth knowledge and experience of the business, its activities and the market, should be briefed on their required involvement in the preparation of the PFI. Subsidiary, divisional, and business unit management should also be briefed on their involvement, as appropriate, and where practical from a confidentiality perspective.

j. Appropriate processes should be planned for obtaining input from all relevant areas of the business, which, in addition to finance, may include some or all of: treasury, tax, operational, commercial and legal functions. Where such functions do not exist in-house, consideration should be given as to whether it is appropriate to obtain input from external service providers to the business. These processes should be implemented, organised and communicated internally, as appropriate, taking into account any confidentiality issues.

Information relating to a target

k. If relevant, appropriate processes should be planned for obtaining PFI input from an acquisition target business.

Relevant accounting policies

l. When planning the PFI, the preparer should identify the accounting policies to be applied in preparing the PFI. In this regard, PFI should usually be prepared in accordance with the entity's key accounting policies and have regard to disclosures of KPIs and APMs insofar as they are material to the PFI and its purpose. Consideration should also be given to whether there are any required or proposed accounting policy or accounting standard changes that should be reflected and, if so, how any changes would impact financial covenant compliance calculations in the PFI.

Format of the PFI and comparison with historical financial information

m. The preparer should consider whether the planned format of the PFI will be capable of being compared with subsequent historical financial information prepared for the period covered by the PFI so that differences and similarities can be evaluated, explained and assessed. The preparer should consider what level of detail and disclosures will be required to address factors that might cause comparability issues such as the impact of a major acquisition or disposal, major strategic change in the business or accounting policy changes.

Responsibilities and timetable for preparation

n. Responsibilities should be clearly planned. Roles should be allocated and co-ordinated, including responsibility for the ultimate internal review and approval of the PFI.

o. A timetable for the preparation of the PFI should be drawn up and communicated to relevant parties. It should include sufficient time for the review and the formal approval process of the PFI by the persons responsible for its preparation/issue, and for any necessary amendments to be made before it is approved.

EXECUTION

Business analysis, key assumptions and inputs

a. PFI should be supported by up-to-date business analysis that is properly grounded in reality, known facts and circumstances. The preparer should identify and collate the appropriate sources of reliable information (business analysis, business plans, strategies and risk analysis) to be used as the basis for the assumptions and inputs used to prepare the PFI.

b. Support for key assumptions and inputs may include:
   - the actual balance sheet in the latest available management accounts (which will form the opening balance sheet in the financial forecast model used to generate the PFI), the basis of which will be updated to reflect any further management accounts that become available during the preparation/review period;
   - historical performance/ precedents (but it should be recognised that basing forecast assumptions on historical precedent may not always be reasonable, for example, it may not be reasonable for the business in question to both grow market share and maintain its historical pricing);
   - current run rate data;
   - the pipeline of work recorded in a customer relationship management system or similar;
   - future planned actions/investments that are supported by research and third-party analysis; and
   - third-party documentary evidence such as the commercial terms of key customer/supplier contracts, market/economic studies, commercial due diligence, experts' reports etc.

c. In developing the assumptions to be applied in the PFI, the preparer should consider the possible range of values for each assumption and the level of uncertainty underpinning the assumption.

d. In addition, consideration should be given to the inter-relationship between key assumptions in the PFI – even if each assumption may appear reasonable in isolation, they may not be reasonable in aggregate.

Other relevant factors

e. The preparer should consider information about the key aspects of the economic and market environment within which the business operates and assess whether there are any economic, market, regulatory, legal, political or other factors which may cause the market to change and impact trading and cash flows, and so should be reflected in the PFI.

f. Consideration should be given to any potential capacity constraints, for example those relating to supply chains, staffing levels, production facilities and distribution channels that may impact the ability to deliver projected results, unless investment or other actions are planned to address these.

Accounting policies

g. In preparing the PFI the appropriate accounting policies identified in the planning phase should be applied. Where relevant, the preparer should take account of the impact of known changes in accounting standards that will apply to the business in future financial periods beyond the current financial year and, if relevant, their impact on any covenant compliance calculations.

Financial forecast model

h. To the extent not already available, a financial forecast model should be built which:
   - is integrated, covering the income statement, cash flow and balance sheet, to ensure that all assumptions are consistently and appropriately reflected in each statement, thereby avoiding errors in the model. If, exceptionally, the model is not fully integrated, steps should be taken to ensure all assumptions are appropriately and consistently reflected in all elements of the PFI;
   - has the functionality to enable the entity's accounting policies to be applied;

- to the extent appropriate (ie, where this is the objective of the PFI), has the functionality to present financial information in a consistent format with the financial information presented in internal management accounts or statutory accounts;
- allows the preparer to input an opening balance sheet consistent with the actual balance sheet in the latest available management accounts;
- is driven by key assumptions and allows these key assumptions to be flexed to enable modelling of changes in key assumptions and the impact of business risks (sensitivity analysis);
- has the functionality to enable financial covenant compliance to be modelled; and
- uses robust formulae and variable inputs and avoids hard coding of numbers within the financial forecast model which would reduce functionality and could result in errors.

i. Quality assurance procedures should be applied to the financial forecast model which may include:
  - undertaking appropriate integrity and validation checks within the model, for example to confirm that the projected income statement, cash flow and balance sheet reconcile with each other;
  - performing test procedures on the calculations within the model. This may include testing the logical integrity and arithmetical accuracy of calculations; and
  - analytical review and testing of model outputs, tracing back through to inputs.

Sense check of the PFI

j. A 'top-down' sense check of the PFI should also be undertaken. Typically, this will be achieved through analytical review of KPIs and by comparing the PFI with recent actual performance to identify unusual/unexpected trends that indicate possible inconsistencies and, potentially, a need for amendments to the key assumptions and/or the workings of the financial forecast model.

Sensitivity analysis and mitigating actions

k. The preparer should apply sensitivities to the PFI (sensitivity analysis) to determine the impact on the PFI of risks and uncertainties and of changing relevant material assumptions, in order to gain an understanding of the impact on the PFI of such changes.

l. The ability of the entity to undertake mitigating actions that may reduce the impact of risks should be considered and, where appropriate, modelled in the sensitivity analysis. These should reflect only those actions within management's control in terms of quantum, timing and impact and should be realistic and justifiable. The cost of implementing such actions should also be reflected.

Consistency with the business model

m. The preparer should be able to articulate whether and how any PFI they prepare is consistent with their business model and strategy. Such questions might include:
  - Is the PFI consistent with the objectives of the business?
  - Is the PFI consistent with the key drivers of success?
  - Is the PFI consistent with how the business model is working currently?
  - Is the PFI consistent with how the business is and might be impacted by external events?
  - Is the PFI consistent with how risks that affect key processes and information are being managed?

EVIDENCE AND DOCUMENTATION

a. Key elements of the process should be evidenced through contemporaneous documentation.

b. Sufficient documentary support should be prepared or obtained, including for:

- the business plans, strategies, risk analysis and business analysis used as the basis of the assumptions underlying the PFI;
- key assumptions and inputs; and
- the accounting policies applied.

c. Approval of the PFI (including all relevant disclosures) by appropriate individuals should be documented. For external PFI this is likely to entail approval by the directors (or equivalents in unincorporated businesses), which should be evidenced in board meeting minutes or their equivalent.