ICAEW Guidance for preparers of prospective financial information

Consultation Response

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Dear Sirs

Guidance for preparers of prospective financial information

We have pleasure in enclosing our response to the consultation on guidance for preparers of prospective financial information. In line with the nature of the proposed guidance, we have sought responses from across a broad spectrum of our advisory practice. We hope this response is informative and useful in supporting your processes to finalise the guidance.

In Appendix 1, we have set out a number of more detailed review points and typos which were noted as part of our review, and which we list for your information.

If there are any matters upon which you require clarification or further information please contact Sue Nyman (sue.nyman@uk.gt.com) or Katie McLellan (katie.mclellan@uk.gt.com).

Yours faithfully

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Question 1

Do you think that the guidance in Parts I and II of the Exposure Draft will be readily understood and capable of application by a wider business audience that is not experienced in capital market transactions?

Response

1.1 The basic principles to make Prospective Financial Information (**PFI**) Relevant, Reliable, Understandable and Comparable (together the **Four Principles**) are considered to provide a helpful framework for preparers of PFI. We believe these should be capable of being understood by a wider business audience that is not experienced in capital market transactions. Therefore we fully support the 'Guidance for preparers of prospective financial information' (the **Guidance**) applying to a wider business audience to provide best practice wherever required.

1.2 The Guidance is relatively silent on the wider purpose of PFI and use by multiple stakeholders other than for capital markets; this could cause confusion in respect to the term 'user needs' and to who the Guidance applies. Appreciating that the Guidance has a general applicability, we would welcome further clarification in this area setting out more specifically the nature of the PFI to which each area applies.

1.3 We have the following specific comments on the paragraphs in Parts I and II as referenced below:

1.4 We believe that the first bullet of paragraph 48 of Part I on page 20 which states that disclosure will need to deal with "*sources of uncertainty*" should be concerned with material uncertainties rather than the current wording which effectively includes all uncertainties.

1.5 With reference to the second bullet in the table on page 27 of Part II under "Execution"/"Business analysis principle (Reliable)" which states: "*Mitigating actions should be considered which may counteract the impact of sensitivities. These should reflect only those areas within management's control in terms of quantum, timing and impact. The cost of implementing such actions should also be reflected*." we suggest that the working group should provide more guidance to specify that the timing of mitigating actions must be reflective of the likely timings for (i) management becoming aware that the sensitised vulnerabilities have crystalised, (ii) management determining to implement the mitigating actions, and (iii) the impact/effect of the implemented mitigating actions on the business materialising.

1.6 With reference to the third bullet on page 27 of Part II under "Reasonable disclosure principle (Understandable) " which states "*Using the sensitivity analysis, the preparer should identify the material assumptions and disclose them clearly*", we believe that the bullet is misleading and should be reworded to reflect that business analysis should be used to identify vulnerabilities in material assumptions, and sensitivity analysis performed to test the effect of those vulnerabilities on the material assumptions under alternative scenarios.

Question 2

Do you agree with the categories of PFI that are included in the scope of the guidance, as set out in section 3 of this consultation paper and in Part I of the Exposure Draft?

Response

2.1 We have assessed the scope of the Guidance and believe it is sensible that it applies to internal and external PFI as set out within the three categories below.

i. Internal PFI;

ii. External PFI not for publication; and

iii. External PFI for publication (reported on or not reported on by external advisers).

2.2 We do note, however, that the nomenclature of the three categories is rather cumbersome. Whilst (i). and (ii). above typically refer to full forecast models with a heavy numerical content, (iii). is usually different in nature due to its limited numerical content and increased verbal content. The use of "External PFI" in (ii) and (iii) infers they are similar which they are not, whereas (i) and (ii) are similar but have different labels. Notwithstanding this, we acknowledge that it is difficult to identify alternative labels given the underlying nature of the three categories of PFI.

2.3 Where information is published externally as part of External PFI, there are broader considerations to apply dependent upon the circumstances but we recognise that this Guidance only forms part of those considerations.

2.4 External PFI is defined in para 4 of the Guidance as PFI prepared in the expectation that the organisation will make it available to external parties for their use. External PFI may be published or unpublished. Arguably analyst's research notes could be caught by the definition of External PFI as the definition does not explicitly state that the 'organisation' making the PFI available is the organisation that is the subject of the PFI. We would welcome clarity on this matter.

Question 3

Are there any impending changes, including in regulation, that should be taken into account in finalising the guidance in the Exposure Draft?

Response

3.1 The Prospectus Regulation will apply from 21 July 2019 and will replace the Prospectus Directive.

3.2 The FCA has indicated that it wishes to phase out the use of the terms “UKLA” or “UK Listing Authority” and instead be referred to as FCA or Financial Conduct Authority.

Question 4

Do you have any comments on the context or on the attributes and preparation principles of PFI set out in Part I of the Exposure Draft?

Response

4.1 Paragraph 18 of Part I on page 15 states that: "*Some types of PFI may include an element of historical financial information, because only part of the period under review is in the future. In such cases, the attributes and principles in this guidance should be applied to the whole period, even when some or most of the information is historical*". Where the period in question is a combination of HFI and PFI, we would welcome further guidance in respect to how the principles outlined in Part I link into the need for PFI to be reliable as considered in Part II to ensure information is meaningful and allow users to draw the appropriate conclusions.

4.2 Paragraph 23 (ii) of Part I on page 16 states that the professional accountant "*shall prepare information fairly, honestly and in accordance with relevant professional standards*". We agree with this statement but believe that the term 'fairly' could be misconstrued. There will be circumstances when the information used forms the basis of negotiation between a buyer and seller. As a consequence the accountant preparing the information will liaise with their client to prepare PFI in a manner that is consistent with their negotiation strategy, notwithstanding that this must be aligned to the relevant professional standards the accountant works within.

4.3 Paragraph 35 of Part I on page 18 correctly states that "*for PFI to be reliable it should be supported by analysis of the entity's business*". We believe this should be expanded to also capture the overall structure and regulatory framework that the entity sits within in order that the underlying assumptions and outputs of the information prepared are in-keeping with the characteristics of the entity that is the subject of the engagement. This would include consideration for whether the entity is:

i. a corporate body;

ii. public body or agency relating to a public body;

iii. charity and/or not for profit; and

iv. a partnership of some form.

4.4 Paragraphs 43-45 of Part I on page 19 refer to understandability and the reasonable disclosure principle "for users". In some large transactions there may be numerous stakeholders and hence a significant number of parties inputting into the underlying assumptions and resultant outputs. The complexity of this may make it difficult to prepare information that can be understood by all relevant users. We believe this point should be expanded upon to highlight the limitations surrounding the differing needs of multiple users.

4.5 Paragraph 60 of Part I on page 22 helpfully explains that comparability is not solely about testing outturn results in the future against the forecast position, but about instilling good behaviour in preparers. Whilst this is noted, it is recognised that assumptions do change over time, whether they be accounting or commercial assumptions or risks crystallising. We believe that it is key that a forecast model's functionality is designed to facilitate possible future comparisons as assumptions change (e.g. material unforeseen changes can be switched on and off in a forecast model to allow comparability to be performed sensibly) and recommend that this be referred to in the Guidance. (perhaps in Part II: General application guidance, page 25 under "Planning"/"Subsequent validation principle (Comparable)").

Question 5

Do you have any comments on the general principles and procedures for the preparation of PFI set out in Part II of the Exposure Draft?

Response

5.1 The first two bullets in the table on page 24 in Part II under “Business analysis principle (Reliable)” express that the preparer of PFI “*should identify whether appropriate business analysis and an up-to-date strategic plan exist*” and, “*if a strategic plan needs to be updated or developed, the preparer should determine who needs to be involved in that process*.” Whilst we agree with this point from a broader planning perspective, we believe that the stakeholders within the business should feed into this process such that it also captures their views and input.

5.2 The general application guidance recognises the important roles that robust financial models play in the preparation of PFI. We agree that the use of a well-designed and robust financial model has an essential role in supporting critical decision-making by businesses, and the preparation of PFI. We consider the Guidance includes a number of helpful references and suggestions, but that this should be further strengthened:

i. Paragraph 4 of Part II page 23: The introduction helpfully refers to relevant guidance on preparing financial forecast models, but at present only refers to one of the ICAEW publications issued by the ICAEW. We suggest it would be helpful to also reference the following publications:

(1) Financial Modelling Code - https://www.icaew.com/-/media/corporate/files/technical/information-technology/excel-community/financial-modelling-code.ashx?la=en and

(2) Twenty principles for good spreadsheet practice - https://www.icaew.com/technical/technology/excel/twenty-principles

ii. The table on page 24 of Part II, the sixth bullet under Business analysis principle (Reliable). The Guidance refers to identifying if the person or party developing the model has “*appropriate financial modelling skills*” – we recommend referring to the ICAEW Spreadsheet Competency Framework which provides a framework for assessing this: https://www.icaew.com/technical/technology/excel/spreadsheet-competency-framework

5.3 The Guidance refers to model checks and consideration of independent testing. We would recommend that appropriate quality assurance processes are applied the planning, execution, evidence and documentation phases. We therefore recommend clarifying and strengthening the guidance on the use and testing of a model in these areas, for example:

i. With reference to the sixth bullet of the table on page 24 of Part II, under “Business analysis principle (Reliable)”. The Guidance refers to the fact that the preparer should “*identify if a financial forecast model exists or whether a model needs to be built*”. We believe this sentence is open to misinterpretation in that a model may not be required. We suggest that this should be reworded to make it clear that a model is required, but that the preparer should establish whether or not the business already has a suitable model. This would be consistent with the guidance in the Execution section on page 25, fifth bullet under Business analysis principle (Reliable). Furthermore, the reference to potential independent testing of the model should be amended to state that the preparer should determine what quality assurance procedures should be applied to the model – which may (but do not have to) include independent testing procedures (often referred to as a “model audit”).

ii. The seventh and eighth bullets of the table on page 24 of Part II under “Business analysis principle (Reliable)” are set out below. We believe that confidentiality also needs to be considered.

Sometimes involving subsidiary/divisional/business unit management and even all senior managers might not be practical in a confidential transaction scenario.

- *"Directors (or equivalents in unincorporated businesses) and other 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 involved in the preparation of the PFI. Subsidiary, divisional, and business unit management should be involved as appropriate.*

- *Processes should be implemented 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 planned, organised and communicated internally."*

iii. The second bullet of the table on page 25 of Part II under "Reasonable disclosure principle (Understandable)" is set out below. We believe that for forecasting long term projects, an annual model may also be appropriate in some circumstances

- *"The PFI should normally include monthly projected balance sheets, income statements, and cash flows, although depending on purpose, circumstances, materiality, seasonality, and the nature of trading cash flows, it may be appropriate for it to be prepared on a quarterly basis."*

iv. The final bullet of the table on page 25 of Part II under "Business analysis principle (Reliable) is set out below". We query whether the Guidance should allow a non-integrated model to be acceptable, even on an "*exceptional basis*". We believe that with all the tools available and availability of external consultants to support the preparer, the preparer of PFI should be capable of producing an integrated model using internal or external resources.

- *"To the extent not already available, a financial forecast model should be built which:*
  – is prepared in the form of an integrated financial forecast model, (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 PFI;"

v. The second bullet of the table on page 26 of Part II commencing *"In preparing the financial forecast model, checks should be undertaken to ensure…"* identifies a number of checks that should be undertaken. However, in the current draft these are a mix of standard validation checks that should be quick to undertake and code ("*that the income statement, cash flow and balance sheets reconcile with each other*") to checks requiring judgement or additional information ("*the stated assumptions are correctly applied*"). Also, we note that checks that the model does not contain arithmetical errors may require significant work if the spreadsheet contains a large number of formulae. We would recommend expanding the guidance here to cover the quality assurance of the model development and highlighting that this is likely to include different forms, for example:

(1) Including appropriate integrity and validation checks within the model – for example to confirm that the project income statement, cash flow and balance sheets reconcile with each other;

(2) Undertaking test procedures on the calculations within the model. This may include testing the logical integrity and arithmetical accuracy of calculations;

(3) Analytical review and testing of model outputs, tracing back through to inputs; and

(4) Benchmarking and testing of input assumptions.

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. This could range from limited internal testing to a formal, external model audit.

Question 6

Do you have any comments on the application note for statements of sufficiency of working capital in capital markets transactions in Part III of the Exposure Draft?

Response

6.1 We believe that in general Part III reads well and is easily understandable.

6.2 However, against the assertion of paragraph 8 of Part III on page 30 that the "*directors are responsible ….and must be fully engaged in the preparation process*", we believe that it is counter-productive to have separate schedules of considerations and techniques at 4.1 "*Summary of illustrative practical considerations and techniques specifically applicable to working capital statements for directors*" on page 35 and a separate summary at 4.2 for preparers on page 37. The preparers' section makes several references to actions required of the directors. We believe that the layout confuses roles and responsibilities.

6.3 Particularly in relation to the evidence and documentation step for the directors to "*formally document and approve"* which is the first bullet on page 37, it should be made clear that the directors' memorandum is expected to summarise the key assumptions, concerns attaching thereto and conclusions reached by the directors before any approval is given.

6.4 We believe that it is a potential shortcoming of the Part III guidance that the working group has determined not to consider the term 'properly compiled' in the context of a working capital statement. This term is a requirement in certain areas of capital markets, most notably profit forecasts and estimates, but is frequently imputed into preparation of working capital statements by investment banks acting as Sponsor/Nominated Adviser and their legal advisers. Moreover in the context of a working capital statement the term 'properly compiled' is not universally understood and is subject to different interpretations with the result of inconsistent market application. If the Guidance is being prepared to set standards and give guidance to preparers of PFI, then it is potentially incomplete if it does not consider what the term "properly compiled" means in the context of a working capital statement and how it should be interpreted and applied by ICAEW members. We acknowledge that the Guidance is for the benefit of those preparing working capital statements not those giving comfort on them; the term 'properly compiled' is used as part of the comfort wording by the latter.

6.5 We have set out below some further points of detail as follows.

i. With reference to the final two sentences of paragraph 2 of Part III on page 29 which state "*Most regulators permit only two forms of working capital statement – either the issuer states that it has sufficient working capital (a clean statement) or that it does not (an adverse statement which is referred to in the ESMA Guidance (defined in 2.4) and in this Part as a qualified statement. The form of the statement is typically set by regulation*." We recommend that the last sentence is amended to read *"The form / content of a qualified working capital statement is typically set by regulation".*

ii. We believe that the final sentence of paragraph 4 of Part III on page 29 which states "*Present requirements are generally considered to be a minimum of twelve months from the date of the investment circular*" is incomplete as the minimum period of twelve months is from the date of Admission in the case of a working capital statement prepared pursuant to the AIM Rules for Companies, being a date which is not the same as the date of the investment circular for AIM (namely an AIM Admission Document).

iii. We believe that paragraph 15 of Part III on page 31 needs to be reworded. The sentence "*If there were significant uncertainties attached to a clean working capital statement….*" should not be possible under ESMA's principles.

iv. We believe that Paragraphs 19 and 21 of Part III on page 32 should refer to covenants and testing them under base case and sensitised scenarios.

v. The first bullet in the table on page 36 of Part III under "Execution" refers to the working capital projections being prepared on a "*consistent basis*" with the historical financial information. We believe further clarification is needed as to what this means in practical terms. For example is the Guidance suggesting that the outputs are in the same form / presentation or that they follow the same accounting policies?

vi. We believe that the guidance in Part III should make reference to dividends being consistent with stated policy by expanding the 13th bullet under "Execution" on page 36 to explicitly reference consistency with the dividend policy disclosures within the investment circular.

vii. With reference to the bullets on "Reasonable worst-case scenario" in the table on page 41 of Part III, we believe the working group should give guidance on how the term reasonable worst case should be applied, although we appreciate that this could have been deliberate on the part of the working party as it is not the ICAEW's role to clarify terms and / or the requirements of regulators..

viii. The fifth bullet under 'Borrowing facilities' in the table on page 40 explicitly references liquidity in terms of the need to consider the clauses of any facility agreement that could be breached. We suggest that explicit references should be added to cover covenants as well as change of control clauses.

ix. We believe that the guidance under 'Working capital projections should be prepared on the basis that the transaction has occurred' in the table on page 39 should reference the requirement for consistency of accounting policies in the case of an Enlarged Group.

x. We believe that FCA PN904.3 is pertinent to committed facilities (which are referred to in the fifth bullet under 'Borrowing facilities' in the table on page 40) and could be usefully be included in the list of references as set out in the table on page 78 of the Annex.

Question 7

Do you have any comments on the application note for profit forecasts in capital markets transactions in Part IV of the Exposure Draft, including the application of relevant aspects of the guidance in other circumstances such as where a listed company gives profit guidance to public investors in a less prescribed form (including guidance known as ‘profit warnings’), and where profit guidance or forecasts are prepared for users other than public investors?

Response

7.1 We believe that Part IV reads well and is generally clear in its messaging.

7.2 Whilst we note that the procedures and considerations of Part II are imported to Part IV, it should be emphasised to a greater extent to preparers of such PFI that although the principal consideration is the ‘profit forecast’, with the natural instinct to then focus on the income statement, it is important for preparers to apply equal rigour to the income statement forecasting as well as the balance sheet forecasting. We believe a balanced approach is good practice and should be expected in all cases unless there are good reasons to the contrary. This is to ensure that all material income and expenditure recognitions reflect proper consideration of timing differences inherent in accounting for the normal trading cycle of the business. In this way, the profit forecast is more robustly assessed if there is a contemporaneous view on balance sheet ratios and metrics in order to guard against incorrect recognitions.

We note the reference to consideration of the need for forecast balance sheets and/or cash flow statements in the third bullet on the table on page 55, but believe that greater emphasis is required.
“*careful consideration should be given as to whether a forecast balance sheet and/or cash flow statement should be prepared as part of the supporting unpublished PFI to assess, for example, the unwinding provisions/accruals and their impact on profit*”

7.3 We note Part IV is silent on the impact of expected future changes in accounting standards with regards to profit forecasts.

Question 8

Do you have any comments on the application note for synergy and stand-alone cost saving statements in capital markets transactions in Part V of the Exposure Draft?

Response

8.1 The nature of several recent Quantified Financial Benefit Statements (QFBS) is to focus on a run rate improvement in costs in, typically, three years' time as set out in the draft ~~g~~Guidance at paragraph 49 of Part V page 66. In practice such statements have very little chance of comparability at the end of that implementation period due to the nature of business and changes from other factors in the intervening time. Other than noting that companies may fail the comparability and subsequent validation test, can the working group propose any solution to what, as paragraph 49 identifies, is potential weakness in current market practice.

8.2 With reference to paragraph 42 of Part V page 65 which states *"A Statement may take a variety of forms that could include, for example, cost synergies, revenue synergies, overall earnings enhancements or stand-alone cost savings anticipated in a bid defence scenario. It is therefore important that the Statement is clear as to the form of the synergies arising. For example, when disclosing cost synergies it should be clear in the Statement whether they relate to trading costs, capital costs or working capital requirements"*. We comment that revenue synergies are rarely the focus within a QFBS due to the disproportionate effort required to prepare such information to the standard required because of the high risks associated with realising revenue synergies.

8.3 With reference to the sixth bullet of the table on page 61 of Part V which states: "*An indication of recurring vs non-recurring financial benefits and clear identification of those which are non-recurring."* We comment that non-recurring financial benefits tend to receive a lesser focus with the emphasis in the QFBS on the level of recurring financial benefits.

Question 9

What, if any, transition arrangements are needed for applying the principles when the final guidance is published?

Response

9.1 Preparers and their advisers operating in a UK capital markets environment have experience in applying the 2003 guidance. For this population we believe that very few transitional arrangements are needed for applying the principles once the final Guidance is published.

9.2 Whilst the corporate finance market outside of the UK capital markets environment is already experienced in creating and assessing PFI, there is a low awareness of the 2003 guidance, including amongst advisers. For this population the transition arrangements for the Guidance will need to focus on ensuring there is sufficient time for a concerted campaign of education to ICAEW members and other relevant parties.

Question 10

Are there any other matters that should be taken into account when finalising the guidance in the Exposure Draft?

Response

10.1 We believe that the tabular presentations in Parts III, IV and V have potential to be adopted as the basis for checklists by some preparers and their advisers, and therefore they should be available to members as downloadable modules.

Appendix 1

1.1 We have set out below some further comments of detail.

i. Part II – paragraph 6 – “judgement” should have an “s” at the end

ii. With reference to the last bullet of the table on page 27 in Part II under “Business Analysis principle (Reliable)” which states “*Support for key assumptions, may also include: -historical performance/precedents (but is 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)”*. We believe this should be expanded to also refer to the ‘current run rate’ base.

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