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Dear Katerina

ICAEW exposure draft "Pro forma financial information: guidance for directors"

We are pleased to have the opportunity to respond the October 2013 exposure draft on "Pro forma financial information: guidance for directors".

We welcome the exposure draft and consultation and are supportive of providing further guidance and clarity for preparers of pro forma financial information. We have responded to each of the consultation queries in the appendix to this letter.

Our primary areas of discussion are in relation to the clarification of certain areas in the light of recent guidance from the European Securities and Markets Authority ("ESMA") and the Financial Conduct Authority ("FCA") where it is now clear that listed companies will be required to prepare pro forma income statements whenever issuing a prospectus where there has been a significant gross change. Consequent on this, there is a need for the guidance to be augmented in certain areas particularly in relation to pro forma income statements and the evidence needed to factually support an adjustment in the context of acquisition accounting for business combinations. In this regard, we have suggested some specific amendments that you may wish to consider when taking this forward.

Should you wish to discuss our response, please contact Kevin Desmond (kevin.desmond@uk.pwc.com) or Chris Greenacre (christopher.greenacre@uk.pwc.com).

Yours faithfully

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APPENDIX

Consultation questions

Q1: Do you have any comments on the background material or the scope of the guidance set out in the Introduction?

Within the Introduction and throughout the exposure draft it refers to the fact that the PD Regulation states that significant gross change will normally be satisfied by the inclusion of pro forma financial information. While this is a direct extract from Item 20.2 of PD Regulation, following recent discussions with the FCA our understanding, and consistent with the tone of the European Securities and Markets Authority Questions and Answers Prospectuses 20th updated version – October 2013 ESMA/2013/1537 ("ESMA FAQ"), is that "normally" in this context actually means "always".

In addition, it has been confirmed that the analysis in ESMA FAQ Question 51 leads to the conclusion that pro forma financial information is only required to be included in an equity securities prospectus when there has been a significant gross change that constitutes a business combination.

Whilst the drafting of the ESMA FAQ is written as if a "transaction" is an acquisition, our view is that these requirements also apply when an issuer has made a significant disposal. The introduction to the guidance should be expanded to mention disposals as well as acquisitions.

It is also clear that whenever pro forma financial information is included in a prospectus, ESMA FAQ Question 54, and in a Class 1 circular under the Listing Rules, LR13.3.3R, on a voluntary basis the rules set out in Annex II to the PD Regulation must be followed in presenting the pro forma financial information. We consider that the text of the guidance should be refined to deal with the distinction between mandatory and voluntary pro forma financial information.

In the body of the guidance a number of changes to Section 1 are necessary to deal with these points:

- Paragraph 5 needs to be split between mandatory pro forma financial information, i.e. in connection with a significant business combination or disposal, and voluntary pro forma financial information, i.e. on a share issue.

- Paragraph 6 can be deleted; we do not believe that the regulatory requirement to illustrate significant gross change, as defined, can be done narratively and pro forma financial information has to be prepared.

- Paragraph 11 should include reference to "Annex II of PD Regulation".

- Paragraph 19; we would suggest amending to say "...........and any preparation and presentation of pro forma financial information......"

Q2: Do you have any comments on the way the principle of 'not misleading' has been applied in the context of pro forma financial information (Section 2)?

We are supportive of the "not misleading" principle and the way in which it has been applied in the draft guidance. This reinforces a core principle to the preparers of pro forma financial information.

Q3: Do you have any comments on the specific guidance on the nature of pro forma financial information (Section 2)?

In light of recent discussions with the FCA and the implications of ESMA FAQ number 51 noted above, we believe that amendments to the text are required; notably to paragraphs 26 and 52 as it can no longer be said "it is general practice not to present a pro forma income statement". What could be said instead is: "Where an equity securities prospectus is being prepared and there has been a significant gross change since the beginning of the last financial year, a pro forma income statement must be presented. In other circumstances, issuers can choose to present a pro forma income statement or follow long standing market practice in addressing the impact on earnings through a narrative statement".

Paragraphs 53 and 54 set out the principle that a pro forma income statement should give effect to a transaction from the commencement of the period. While we agree with this concept and the example given, further thought and clarity needs to be given as to how to treat an acquisition and its associated impact on the income statement.

We have two specific areas of concern:

Firstly, in a pro forma net asset statement or balance sheet practice is to use the actual purchase price paid or the price to be paid would be used notwithstanding that it is to be paid at a later date than the date at which the pro forma statement is being said to be drawn up. Is this a valid basis for the income statement in light of the principle outlined in the guidance that an income statement should give effect as if the transaction had occurred at the commencement of the period?

You could argue that the income statement principle implies that the purchase price should be discounted back to the commencement of the pro forma income statement period. However, practice would appear to be, both in the rare cases seen to date in the UK and under similar requirements in the USA, that the purchase price is not discounted back.

A consistent conceptual basis needs to be spelled out to describe what is expected to be done i.e. that you fix elements by reference to the actual terms of the transaction and map those backwards rather than seeking to re-measure the transaction as if it had occurred at the commencement of the period or at the last balance sheet date.

On reflection paragraph 54 needs to address this more clearly. For example it should make it clear that when adjusting interest cost for the effects of a share issue or the receipt of the proceeds from selling a significant business, it is the actual proceeds that are to be received that are applied to eliminate a borrowing on which the interest cost was incurred in the year.

Our second area of concern is that similar considerations to those described above apply to the purchase price allocation exercise that would be conducted under the requirements of IFRS3 Revised: Business Combinations ("IFRS3R"). How is the pro forma income statement principle set out in paragraph 53 applied in this context? In particular, as to how this is applied to the amortisation of identified intangible assets as well as the other income statement impacts of business combination accounting. Strict application of the principle, that a transaction is said to have taken place at the commencement of the period, would lead to issuers having to perform a fair value exercise on the acquired business as at the opening date of the period.

A more practical solution consistent with the concept described above would be to use the actual date of acquisition or the date of the prospectus, if earlier, and to map the consequences backwards. This has the advantage that any amortisation of acquired intangibles is shown at the amount that will be charged or close to that to be charged in the issuer's post-acquisition financial reporting.

Q4: Do you have any comments on the specific guidance on the presentation of pro forma financial informations (Section 3)?

Section 3.1 Presentation of a narrative description is given undue prominence in the guidance and should be moved to later within the document.

Paragraph 38 referring to an example of the cash receipts from a share offer alone can be deleted as the FCA has confirmed in discussions with us that a capital increase is not to be considered a significant gross change irrespective of its size.

Paragraph 45 refers to multiple significant gross changes and uses a post balance sheet fundraising as an example. Given that it has been confirmed through our discussions with the FCA that fundraising does not represent a significant gross change, it is our view that this paragraph should be modified accordingly.

One area where additional guidance should be included is as regards dealing with the impact of a significant disposal when preparing a pro forma income statement.

Q5: Do you have any comments on the specific guidance on adjustments (Section 4)?

We welcome the guidance given covering some of the more challenging adjustments in pro forma financial information within Section 4.

Paragraph 103 discusses the principles of certain cost and revenue eliminations arising on an initial public offering or the combination of two or more entities on an acquisition. A notable omission is consideration of how to treat any trading or balances between an acquirer and an acquiree. In presenting the pro forma financial information, should these inter-company elements be eliminated to present a more representative position? Our view is that they should not be, however, appropriate footnotes to the pro forma could be provided to explain the extent of intra-entity trading or balances. We do, however, believe the guidance should be updated to reflect this possibility.

Consistent with long standing market practice, the bar for inclusion of the fair value adjustments associated with an acquisition has been set at a reasonably high level, as set out in in paragraphs 111 to 115 of the guidance. However, such an approach is inconsistent with the fact that under IFRS3R an issuer may use or have used provisional fair value based on their own estimations in drawing up their financial statements. It would seem perverse that when preparing pro forma income statement for a financial year where an acquisition occurred in the year that adjustments permitted by GAAP would not meet the factually supportable criteria. Our view is that it is appropriate to set the bar at a level consistent with that which is permitted under GAAP.

Other comments: paragraph 90 needs amending to modify the language "that a preparer is not obliged to present pro forma financial information" in light of the comments already raised above.

Q6: Are there any other matters that should be taken into account when finalising the new guidance in Part 3?

We have no other matters to raise other than those covered in consultation questions 1 to 5.

Q7: Do you have any comments on the transitional arrangements discussed in Part 2 of this document?

We believe that the guidance should be implemented as soon as practicable following its publication and therefore a two month transition period is appropriate from our perspective.