ICAEW CORPORATE FINANCE FACULTY

PRO FORMA FINANCIAL INFORMATION GUIDANCE FOR DIRECTORS

EXPOSURE DRAFT – OCTOBER 2013

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INTRODUCTION

Part 3 of this document contains the exposure draft of proposed new guidance for directors on preparing pro forma financial information. It is issued in the context of the Prospectus Directive (Directive 2003/71/EC) which was implemented in the UK from 1 July 2005 in the Prospectus Rules and in Part VI of the Financial Services and Markets Act 2000. Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing the Prospectus Directive (the PD Regulation) sets out the form and content of prospectuses. The PD Regulation is directly applicable in the UK and does not need implementing legislation.

Under the PD Regulation, a company which issues a prospectus in connection with an equity issue must, in the case of a 'significant gross change', include a description of how the transaction might have affected the assets and liabilities and earnings of the issuer, had the transaction been undertaken at the commencement of the period being reported on or at the date reported.

The PD Regulation indicates that this requirement will normally be satisfied by the inclusion of pro forma financial information and, where this is the case, stipulates the presentation of that information.

Prior to 2005, the UK's Listing Rules and reporting requirements for listed companies were set by the London Stock Exchange (until 2000) and by the Financial Services Authority. The Listing Rules included the framework for pro forma financial information.

In 1998, ICAEW published Technical Release TECH 18/98 *Pro Forma Financial Information, Guidance for Preparers under the Listing Rules*. The guidance discussed practical application of the relevant Listing Rules and provided commentary based on market practice to help directors, the preparers of pro forma financial information.

TECH 18/98 is based on the Listing Rules extant when it was published and the guidance has become out of date.

In 2012 ICAEW carried out a pre-consultation of market participants to ascertain the need for new guidance to replace TECH 18/98. The pre-consultation highlighted areas that would benefit from review and current issues for consideration. In May 2013, ICAEW published *Pro forma financial information, Status report on updating guidance for directors* which described the case for updating TECH 18/98 and invited comments on the areas identified for review when developing new guidance.

The exposure draft in Part 3 draws on the results of the Working Group's pre-consultation with market participants and on the experience of Working Group members. In developing the proposed new guidance the Working Group also considered comments received in response to the Status Report.

1. CONSULTATION PROCESS

1.1 Project history

In 2012 ICAEW established, through its Corporate Finance Faculty, a Working Group to review the need for new guidance to replace TECH 18/98. Assuming such a need existed the Working Group would also develop such guidance. Members of the Working Group are listed in Annex 1.

During 2012 the Working Group contacted a range of market participants to identify pertinent matters relating to pro forma financial information and to discuss the need for up-to-date guidance. The pre-consultation indicated that new guidance would serve a useful purpose and highlighted areas for review that would potentially require changes to the guidance in TECH 18/98.

In May 2013 the Working Group set out the case for updating TECH 18/98 in the publication *Pro forma financial information, Status Report on updating guidance for directors* (the Status Report). The Working Group invited further comments on the main areas identified in the pre-consultation and on which it expected to focus when developing up-to-date guidance. It also held further meetings with market participants. Providers of market feedback are listed in Annex 2.

Part 2 explains key matters in the development of the proposed new guidance. The key matters include comments received on the Status Report.

The exposure draft of new guidance in Part 3 is the basis for formal consultation. Following the consultation period we will publish the finalised guidance together with the written responses to the consultation.

1.2 Consultation questions

The Working Group is seeking responses from interested parties to any or all of the following questions regarding the exposure draft of new guidance for preparing pro forma financial information set out in Part 3 of this document.

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

2. 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)?

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

4. Do you have any comments on the specific guidance on the presentation of pro forma financial information (Section 3)?

5. Do you have any comments on the specific guidance on adjustments (Section 4)?

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

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

1.3 How to respond

Comment letters should be received by 14 February 2014 and be sent either by email as a Word file to katerina.joannou@icaew.com, or by post to:

Katerina Joannou
ICAEW
Chartered Accountants' Hall
Moorgate Place
London EC2R 6EA
United Kingdom

It would help in the analysis of responses if organisations could provide information on their size and activities and if individual commentators could describe their background and experience.

Respondents should indicate specifically whether their comments are to be treated as confidential. Standard disclaimers in responses received by email will be disregarded for this purpose. Unless otherwise stated, responses will be regarded as being on the public record.

2. DEVELOPING THE GUIDANCE

2.1 Background

The Prospectus Directive (Directive 2003/71/EC) is supported by Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing the Prospectus Directive (the PD Regulation). This sets out the detailed disclosure requirements for prospectuses. A prospectus may be required to be prepared either because securities are to be admitted to trading on an EU Regulated Market or a public offer of securities is being made. The PD Regulation applies to prospectuses relating to shares in companies and other transferable securities such as depositary receipts, bonds or other forms of securitised debt.

Under the PD Regulation, in the case of a 'significant gross change', a prospectus relating to an issue of equity securities must contain a description of how the transaction might have affected the assets and liabilities and earnings of the issuer, had the transaction been undertaken at the commencement of the period being reported on or at the date reported (Annex I, Item 20.2). Similar provisions apply to Class 1 circulars under the Financial Conduct Authority's (FCA's) Listing Rules.

The PD Regulation states that this requirement will normally be satisfied by the inclusion of pro forma financial information that complies with the requirements set out in Annex II Pro Forma Financial Information Building Block.

The Prospectus Directive was implemented in the UK from 1 July 2005 in the Prospectus Rules and by way of amendments to Part VI of the Financial Services and Markets Act 2000. The Prospectus Rules are relevant to entities applying for admission of their securities to trading on a regulated market in the United Kingdom, such as applicants to the Main Market of the London Stock Exchange, NYSE Euronext London and the ISDX Main Board. The Prospectus Rules are also applicable to issuers offering securities to the public in the United Kingdom (unless an exemption applies).

Pro forma financial information presented in a prospectus must comply with Annex II of the PD Regulation. Annex II contains requirements governing the preparation and presentation of pro forma financial information and also contains requirements governing the reporting on pro forma financial information by a reporting accountant.

Pro forma financial information may be included voluntarily in admission documents (which are not also prospectuses) by applicants to AIM and the ISDX Growth Market where the applicants wish to illustrate the effect of a significant event or transaction. The PD Regulation requirements in respect of pro forma financial information do not apply to such documents.

TECH 18/98 deals with guidance for preparers of pro forma financial information. In the UK, there are separate requirements and guidance on the work to be performed by a reporting accountant engaged to report publicly on pro forma financial information contained in the Financial Reporting Council's Standard for Investment Reporting (SIR) 4000, *Investment Reporting Standards Applicable to Public Reporting Engagements on Pro Forma Financial Information*. SIR 4000 includes an Annexure which indicates those parts of TECH 18/98 that are no longer applicable and those that continue to be relevant. The Annexure notes that it will cease to be applicable as and when ICAEW publishes the replacement for TECH 18/98.

There is no internationally applicable guidance for preparers. For reporting accountants, the International Auditing and Assurance Standards Board's pronouncement International Standard on Assurance Engagements (ISAE) 3420 *Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus* sets out guidance on reasonable assurance engagements undertaken by professional accountants to report on the compilation of pro forma financial information by entities for inclusion in their prospectuses.

Like TECH 18/98, the proposed new guidance is restricted to the role of preparers of pro forma financial information.

2.2 Scope of the guidance

The proposed new guidance relates to pro forma financial information as such term is used in the PD Regulation. Under the PD Regulation, in the case of a 'significant gross change', pro forma financial information may be presented to satisfy the requirement for a description of how the identified transaction might have affected the assets and liabilities and earnings of the issuer.

The PD Regulation defines a 'significant gross change' as a variation of more than 25% relative to one or more indicators of the size of the issuer's business, in the situation of an issuer due to a particular transaction, with the exception of those situations where merger accounting is required.

The proposed guidance aims to provide practical help for applying the preparation and presentation requirements of Annex II of the PD Regulation, including the criteria that pro forma adjustments should be clearly shown and explained, directly attributable to the transaction and factually supportable, taking account of material published by the European Securities and Markets Authority (ESMA) in its publications:

- *Update of the CESR recommendations on the consistent implementation of Commission Regulation No 809/2004/EC implementing the Prospectus Directive* (ESMA Recommendations); and
- *Questions and Answers, Prospectuses* (ESMA Q&A).

TECH 18/98 recognised that there is a range of events or transactions for which pro forma financial information might typically be presented, falling into the general categories of business combinations, divestments, and issues/reductions of debt or equity. The proposed new guidance similarly recognises this diversity of circumstances.

2.3 Guidance pursuant to market feedback and updated market practice

The Working Group considered the preparation and presentation requirements of Annex II of the PD Regulation regarding the nature and presentation of pro forma financial information and the adjustments to an issuer's assets and liabilities and earnings as a result of the transaction.

The new guidance includes considerations for preparers based on the Working Group's experience and on market practice. It also takes account of suggestions received from respondents to the Status Report published in May 2013.

2.3.1 Principle for pro forma financial information

While developing practical help for applying the preparation and presentation requirements of Annex II of the PD Regulation, the Working Group considered the requirement in the regulatory regime in place when TECH 18/98 was prepared, that the pro forma financial information presented must not be misleading. Although the PD Regulation does not repeat that requirement, the principle of not presenting misleading information can be traced across legal and regulatory requirements. For example, it is found in:

- section 89(1), Part 7 of the UK's Financial Services Act 2012;
- Listing Rule 13.3.3R, published by the FCA;
- advice from the Committee of European Securities Regulators (ESMA's predecessor) that pro forma information, if not prepared with due care, might confuse or even mislead investors (CESR/03-208, paragraphs 38-40); and
- question 52 and question 54 of ESMA Q&A.

The Working Group was of the view that it continues to remain an important concept in the context of pro forma financial information and has retained it as a guiding principle in the new guidance.

2.3.2 What pro forma financial information represents

The new guidance confirms the clarification in TECH 18/98 that pro forma financial information does not purport to represent what the issuer's actual financial position or results would have been had the transaction occurred at the date assumed for the purpose of its preparation. Rather, pro forma financial information is a hypothetical illustration of the impact of a transaction on the issuer's assets and liabilities or, as applicable, earnings.

2.3.3 Purpose of pro forma financial information

The new guidance addresses the importance of identifying the purpose of the pro forma financial information, including information that is supplemental to that which is presented to meet the PD Regulation requirement to show the impact on assets and liabilities and earnings.

The new guidance also sets out matters typically disclosed in an introduction to pro forma financial information in an investment circular.

2.3.4 Presentation of information

Pro forma financial information is presented in the context of a PD Regulation requirement for a description of how a transaction might have affected the assets and liabilities and earnings of the issuer, had the transaction been undertaken at the commencement of the period being reported on or at the date reported.

In the experience of the Working Group the most commonly encountered form of pro forma financial information in the United Kingdom relates to impacts on net assets. The new guidance, however, comments on considerations that may arise when an issuer does present a pro forma statement of profit or loss and other comprehensive income.

The commentary on presentation also includes considerations when presenting information that is supplemental to that which is presented to meet the PD Regulation requirement to show the impact on assets and liabilities and earnings.

The nature of the PD Regulation requirement is such that it may also be satisfied by a narrative description and the new guidance comments on market practice when pro forma financial information is not meaningful to present or is not possible to produce. In these circumstances, the effect on assets and liabilities and earnings is presented by way of narrative description.

2.3.5 Accounting policies

The guidance in TECH 18/98 on accounting policies has been updated to comply with the PD Regulation and the new guidance refers to the FCA's UKLA Technical Note *Hostile Takeovers* (UKLA/TN/305) to describe the application of an acquirer's policies on an acquisition and the impact on pro forma financial information if there is limited access to information relevant to the target.

2.3.6 Criteria for adjustments

The Listing Rules in force in 1998 included the requirement that the reporting accountant should report that 'all appropriate' adjustments had been made. The reporting requirements under the PD Regulation do not include this obligation. The Working Group does not believe that the absence of this obligation has any effect in practice and the new guidance considers the principles of consistency, completeness and materiality of adjustments. The requirements of the PD Regulation that adjustments should be clearly shown and explained, directly attributable to the transaction and factually supportable, are very similar to those under the old Listing Rules. As potential adjustments that do not meet the criteria would not be appropriate, the Working Group was of the view that the PD Regulation did not give rise to a significant change in the treatment of adjustments.

The new guidance provides commentary to help apply the criteria for adjustments so as to prevent the pro forma financial information from being misleading. The commentary, which includes guidance on disclosures, also considers the omission of potential adjustments that do not satisfy the PD Regulation 'factually supportable' criterion provided that this does not result in information being misleading.

2.3.7 Common adjustments

The new guidance provides up-to-date considerations pertaining to common adjustments, including additional material for adjustments relating to:

- multiple significant gross changes in Section 3.2.2;
- foreign currency translation in Section 4.2.7;
- debt repayment following an issue of securities in Section 4.2.8; and
- fair values (including where these are available for more than one date) in Section 4.2.9.

2.4 Transition from TECH 18/98

The proposed new guidance in Part 3 is intended to replace ICAEW Technical Release TECH 18/98 *Pro Forma Financial Information, Guidance for Preparers under the Listing Rules.*

Once the Working Group has completed its consideration of the comments on the proposed new guidance, ICAEW will publish the final text in the form of a Technical Release. The Working Group considers there should be a transitional period between the publication date of the Technical Release and its implementation, and is minded to set this at two months.

2.5 Wider application of the guidance

It is possible for pro forma financial information to be included in an investment circular where there are no regulatory requirements governing its presentation. This guidance may be useful for preparers in relation to pro forma financial information prepared and presented in such situations.

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1. Introduction

1.1 What pro forma financial information represents

1. Pro forma financial information represents a hypothetical illustration of the impact of a transaction or transactions on an issuer's assets and liabilities and earnings. Pro forma financial information does not purport to represent what the issuer's actual financial position or results would have been had the transaction occurred at the date assumed for the purpose of its preparation.

1.2 Pro forma information under the PD Regulation

2. A prospectus relating to an offer, or a request for admission to trading, of transferable securities must, in the case of a 'significant gross change', include a description of how the transaction might have affected the assets and liabilities and earnings of the issuer, had the transaction been undertaken at the commencement of the period being reported on or at the date reported. This requirement is set out in Annex I, Item 20.2 of Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing the Prospectus Directive (the PD Regulation).

3. The PD Regulation states that this requirement will normally be satisfied by the inclusion of pro forma financial information and the PD Regulation stipulates:

   - what information is to be presented and how; and
   - the scope of the report prepared by independent accountants (in the UK, reporting accountants) or auditors that must accompany the pro forma financial information.

4. The PD Regulation defines a 'significant gross change' as a variation of more than 25% relative to one or more indicators of the size of the issuer's business, in the situation of an issuer due to a particular transaction, with the exception of those situations where merger accounting is required.

5. Pro forma financial information may be used for an issue of capital on an initial public offering or a subsequent rights issue, open offer or placing when the purpose may be to illustrate the reduction in gearing that results from the application of the proceeds of the issue in repaying debt. Another common instance of pro forma financial information is to illustrate the effect of an acquisition or disposal on the net assets of the issuer.

6. Despite the widespread use of pro forma financial information in the circumstances described above, issuers should be aware that it is not always necessary to prepare such information in order to meet the regulatory requirement for the inclusion of a statement of the impact of a transaction for example, where a straightforward transaction can be described through a narrative description.

7. The requirement in Annex I, Item 20.2 is also repeated under:

   - Annex XXIII Proportionate Schedule for Minimum Disclosure Requirements for the Share Registration Document for Rights Issues, Item 15.2; and
   - Annex XXV Proportionate Schedule for Minimum Disclosure Requirements for the Share Registration Document for SMEs and companies with reduced market capitalisation, Item 20.2.

8. The provisions in Annex I, Item 20.2 also apply to circulars under the Financial Conduct Authority's (FCA's) Listing Rules.

1.3 Other rules, guidance and market practice

9. The European Securities and Markets Authority (ESMA) has guidance on pro forma financial information in its publication *Update of the CESR recommendations on the consistent implementation of Commission Regulation No 809/2004/EC implementing the Prospectus Directive* (ESMA Recommendations), which will be taken into account by the FCA in determining whether an issuer has complied with the PD Regulation.

10. Common supervisory approaches and practices towards the preparation of pro forma financial information are included in the ESMA publication, *Questions and Answers,*

Prospectuses (ESMA Q&A). This publication includes confirmation that an issuer can voluntarily include pro forma financial information in a prospectus and that such voluntary pro forma financial information must be prepared according to Annex II.

11. If a listed company includes pro forma financial information in a Class 1 circular, a related party circular or a circular relating to the purchase by the company of 25% or more of its issued equity shares (excluding treasury shares), Listing Rule 13.3.3R requires it to comply with the requirements for pro forma financial information set out in the PD Regulation.

12. Pro forma financial information may be included voluntarily in admission documents by applicants to AIM and the ISDX Growth Market. Unless the admission document is also a prospectus, the PD Regulation requirements in respect of pro forma financial information do not apply.

1.4 Scope and application of the guidance

13. This guidance provides commentary and practical help for preparing pro forma financial information that complies with the requirements in the PD Regulation, including the criteria for pro forma financial information in Annex II, and relevant ESMA Recommendations. This guidance is underpinned by the principle that pro forma financial information should not be misleading in the context of the investment circular in which it is presented. Section 2.2 discusses this principle.

14. This guidance may also be useful in situations where there are no regulatory requirements governing preparation of pro forma financial information.

15. This guidance does not address the work performed by the reporting accountant, although the reporting accountant has regard to the criteria for pro forma financial information in Annex II in the process of reaching an opinion.

1.5 Terms used in the guidance

16. For ease of explanation, reference has been made to International Financial Reporting Standards (IFRSs) throughout this guidance. However, it is recognised that other financial reporting standards may be applicable to the preparation of the financial information that forms the basis for the pro forma financial information to which this guidance applies. It is therefore necessary to consider any explanation that refers to IFRSs in the light of the relevant financial reporting standards employed in preparing the unadjusted financial information and to be aware that the guidance given may not be directly applicable where those standards are different.

17. The guidance uses the names of financial statements as they are referred to in IFRS. Hereafter the guidance refers to 'statement of financial position' instead of 'balance sheet' and to 'statement of profit or loss and other comprehensive income' instead of 'profit and loss account'. However, where the guidance refers to disclosure requirements or guidance from other sources such as the PD Regulation, ESMA Recommendations or ESMA Q&A, the terminology used is consistent with the underlying material.

18. The term investment circular, when used in the guidance, refers to a prospectus where the PD Regulation is applied by European legislation or to a circular to which the PD Regulation provisions relating to pro forma financial information are applied by the Listing Rules.

19. The party responsible for the investment circular and any pro forma financial information contained within it is referred to in the guidance as the issuer.

1.6 Structure of the guidance

20. The sections that follow each address a specific theme relating to pro forma financial information; namely:

    - nature of information;
    - presentation of information; and
    - adjustments.

21. The guidance reproduces regulatory provisions related to pro forma financial information and sets out commentary and/or analysis of market practice for each of these themes.

1.7 Effective date

22. The implementation date of this guidance is [xxxx] although early implementation is encouraged.

23. This guidance replaces ICAEW Technical Release TECH 18/98 *Pro Forma Financial Information, Guidance for Preparers under the Listing Rules.*

2. Nature of information

2.1 Definition

PD Regulation

Annex I Minimum Disclosure Requirements for the Share Registration Document (schedule)

Item 20. Financial Information Concerning The Issuer's Assets And Liabilities, Financial Position And Profits And Losses

Item 20.2. Pro forma financial information

In the case of a significant gross change, a description of how the transaction might have affected the assets and liabilities and earnings of the issuer, had the transaction been undertaken at the commencement of the period being reported on or at the date reported.

This requirement will normally be satisfied by the inclusion of pro forma financial information.

This pro forma financial information is to be presented as set out in Annex II and must include the information indicated therein.

Pro forma financial information must be accompanied by a report prepared by independent accountants or auditors.

24. The PD Regulation states that the requirement to describe the effects of a significant gross change will normally be satisfied by the inclusion of pro forma financial information. In cases where the inclusion of pro forma financial information in the prospectus is not feasible or might not be a fair way to describe the transaction, issuers will still have to comply with the requirement under Annex I, Item 20.2 (ie, by providing a narrative description) but would not have to follow Annex II. This is confirmed in question 50 of ESMA Q&A.

25. Listing Rule 13.4.1(5) requires that a Class 1 circular includes a statement of the effect of the transaction on the issuer's earnings and assets and liabilities. Pro forma financial information is often presented in a Class 1 circular as a means to comply with this requirement.

26. The typical approach in the UK is for the description of how the transaction might have affected the earnings of the issuer to be satisfied by a narrative description, while the description of how the transaction might have affected the assets and liabilities is typically satisfied by the inclusion of pro forma financial information presented as set out in Annex II. When using pro forma financial information to satisfy the requirement of how the transaction might have affected the assets and liabilities of the issuer it is usual for issuers to present a pro forma net assets statement rather than a pro forma statement of financial position.

27. Section 3.1 includes guidance on presentation of information for issuers who elect not to, or are not able to, present pro forma financial information and, instead, satisfy the requirements by providing a narrative description. Section 3.2 covers presentation of information for directors who elect to satisfy the requirement by including pro forma financial information presented as set out in Annex II.

2.2 Principle for pro forma financial information

2.2.1 'Not misleading' principle

28. This guidance is underpinned by the principle that pro forma financial information presented must not be misleading. While not explicit in the PD Regulation, the principle of not having misleading information can be traced across legal and regulatory requirements.

29. Because pro forma financial information addresses a hypothetical illustration of the impact of a transaction (or transactions) on the issuer's assets and liabilities or earnings, it does not represent a company's actual financial position or results. Furthermore, pro forma financial information does not purport to represent what the issuer's actual financial position or results would have been had the transaction occurred at the date assumed for the purpose of its preparation. The preparation of pro forma financial information makes use of information that is already available to the issuer and which has been prepared for other purposes. Such information may come from different sources and relate to different dates or periods, and may not, therefore, be consistent or directly matched. The resultant illustration needs to be read in the context of the general limitations on its preparation and its necessarily limited objective, as well as in the light of any specific limitations disclosed within the pro forma financial information. These limitations may include the omission of relevant adjustments because they do not meet one or more of the regulatory criteria. The illustration should also be read in the light of the investment circular as a whole

30. Issuers should be aware that the principle that information should not be misleading is also important to the reporting accountant engaged under the PD Regulation to report on pro forma financial information. This is evident in:

- Standard for Investment Reporting (SIR) 4000, *Investment Reporting Standards Applicable to Public Reporting Engagements on Pro Forma Financial Information*, paragraph 46; and

- International Standard for Assurance Engagements (ISAE) 3420, *Assurance Reports on the Process to Compile Pro Forma Financial Information Included in a Prospectus,* paragraph 26(b).

2.2.2 Judging whether information is misleading

31. To enable issuers to judge whether pro forma information is misleading, they need to identify the purpose of that information. Historical and forecast financial information is part of a range of information that investors use to decide what assessment to make and what action to take, if any, in response to the investment circular. Pro forma financial information provides investors with illustrative information about the impact of proposed transactions on historical information and so may provide some assistance in their assessment. In judging whether pro forma financial information is misleading, an issuer should have regard, among other things, to the relevance of the information to any assessment being made and the actions to be taken on the basis of the investment circular.

32. Even where pro forma financial information satisfies the individual regulatory conditions relating to its preparation, it could still be misleading if it gives users of the investment circular a view of the effect of the transaction on the unadjusted information which differs from what would reasonably be expected and, thereby, materially affects users' assessment of the transaction.

33. In making their judgement, issuers consider the pro forma financial information as a whole having regard to each of the components of the information set out below, in the context of the transaction or transactions that the pro forma financial information is illustrating:

- the introductory narrative explaining the purpose and nature of the pro forma financial information;

- the historical unadjusted information, the pro forma adjustments and the resulting pro forma financial information; and

- the notes explaining, inter alia, the sources of information and basis for the adjustments.

34. Issuers also have regard to information such as the operating and financial review and other information included in the investment circular in which the pro forma financial information is presented.

35. As noted above, pro forma financial information that is prepared and presented in accordance with the requirements of the PD Regulation may still be misleading. The action of 'standing back' and considering pro forma financial information having regard to the matters referred to in the preceding paragraphs can safeguard against this risk.

3. Presentation of information

3.1 Presentation of a narrative description

36. As discussed in Section 2.1, an issuer may not be able to, or may elect not to present pro forma financial information and, instead, may satisfy the requirement to describe the effects of a significant gross change by providing a narrative description of the effect of the transaction on the assets and liabilities or, as applicable, earnings of the issuer.

37. An example of where an issuer may not be able to present pro forma financial information is in the case of a contested acquisition where the issuer's access to information relevant to the target is limited and the issuer may not be able to present pro forma financial information on the basis of its own accounting policies. An issuer may also not be able to present a pro forma statement of profit or loss and other comprehensive income where there is uncertainty around the impact of the transaction on the issuer's earnings.

38. A situation where an issuer might elect not to present a pro forma net assets statement might be one where the impact of the transaction is straightforward, for example an increase in cash balances consequent on a share offer.

3.1.1 Narrative description relating to effect on assets and liabilities

39. A narrative description of the effect of a transaction on assets and liabilities will generally describe the principal accounting effects of the transaction. For a share issue, this may typically involve noting the receipt of cash proceeds, which will lead to an increase in cash balances (or a reduction of debt balances) by an amount corresponding to the net proceeds after deducting expenses of the issue.

40. For an acquisition, the description may contain the overview that, if funded from cash or borrowings, there is expected to be no impact on consolidated assets and liabilities. If the acquisition is funded by a new issue of shares, the description might state that consolidated net assets will increase by the fair value of the shares to be issued. The description may then explain that, following completion of the acquisition, the acquirer will undertake an exercise to identify the fair value of the assets and liabilities acquired, which will lead to an increase in the applicable consolidated asset or liability, and that any purchase consideration in excess of the net fair value of the identified assets and liabilities acquired will be recognised as goodwill.

41. For a disposal, the description may explain that the consolidated assets will increase by the net proceeds of disposal less the book value of the assets of the entity to be disposed of, and that the consolidated liabilities will decrease by the book value of liabilities of the entity to be disposed of. Where it is clear that the overall effect will be an increase in consolidated net assets or a decrease in consolidated net assets, the description may also state this. If the investment circular discloses that the purpose of the disposal is to generate funds for a specified purpose such as the repayment of a debt or the payment of a special dividend, this may also be referred to in the description.

3.1.2 Narrative description relating to effect on earnings

42. A narrative description of the effect of a transaction on earnings will generally be expressed in the form of a directional indicator.

43. For an acquisition or disposal, the description may be presented in the form of a general description of the accounting effects of the transaction on earnings or on profit before tax, tax and interest individually. In the case of an acquisition where a fair value exercise has not been performed, the impact on earnings may be uncertain, particularly if the fair value exercise is likely to impact the value of the assets that might be depreciated or amortised. In such circumstances this uncertainty should be explained.

3.2 Presentation of pro forma financial information

3.2.1 Introductory text

PD Regulation

Article 5 (extract)

Pro forma financial information should be preceded by an introductory explanatory paragraph that states in clear terms the purpose of including this information in the prospectus.

PD Regulation

ANNEX II Pro forma financial information building block

Item 1

The pro forma information must include a description of the transaction, the businesses or entities involved and the period to which it refers, and must clearly state the following:

a) the purpose to which it has been prepared;

b) the fact that it has been prepared for illustrative purposes only;

c) the fact that because of its nature, the pro forma financial information addresses a hypothetical situation and, therefore, does not represent the company's actual financial position or results.

44. The introductory text to pro forma financial information typically contains statements explaining:

- that the pro forma financial information has been prepared for illustrative purposes only, and in accordance with Annex II of the PD Regulation;
- that the pro forma statement of profit or loss and other comprehensive income has been prepared to illustrate the effect on the issuer for the stated period as if the proposed transaction had taken place on the first day of the period;
- that the pro forma net assets statement or pro forma statement of financial position has been prepared to illustrate the effect on the net assets of the issuer as if the proposed transaction had taken place on the date of the issuer's statement of financial position;
- that, as a result of its nature, the pro forma financial information addresses a hypothetical situation and therefore does not represent the actual financial position or results following the transaction; and
- the source of the unadjusted financial information from which the pro forma financial information has been prepared.

3.2.2 Presentation of multiple significant gross changes

45. The purpose of pro forma financial information is to illustrate the effect of a specific transaction which is a significant gross change on the assets and liabilities or earnings of an issuer. Where there has been another significant gross change since the period or date of the unadjusted information relating to the issuer, it will be necessary to consider whether to include in a pro forma statement the effects of that other significant gross change. For example, if an issuer is intending to present pro forma information in relation to a proposed acquisition and it has undertaken a significant fundraising between the date of the unadjusted information and the date of the investment circular, it should consider whether or not to include the effects of the fundraising and the effects of the proposed acquisition together in a single statement of pro forma financial information.

46. Similar considerations arise in circumstances where an investment circular is produced covering more than one transaction, each of which will result in a significant gross change. This might be the case where an issuer with a Premium Listing on the Main Market is undertaking a number of Class 1 transactions or is undertaking a group reorganisation affecting various holdings in subsidiary undertakings and associated companies. Where these transactions are not independent of each other, pro forma financial information would illustrate the combined impact of the transactions. Where the transactions are independent of each other, the pro forma financial information would illustrate separately the adjustments and impact on the issuer relating to each transaction on an individual basis, and would also generally illustrate the impact on a combined basis.

47. The clearest way to illustrate the transactions may vary from case to case. Depending on the number of transactions and their nature, it may be appropriate to illustrate by way of:

- separate tables for each transaction and then a combined table; or
- one combined table.

3.2.3 Identifying the purpose of pro forma financial information

48. Disclosure of the purpose for which pro forma financial information is prepared is fundamental to its presentation. The purpose of pro forma financial information is usually to illustrate the effects of one or more transactions on certain unadjusted financial information or aspects of that information. It should therefore clearly identify the specific transactions and unadjusted financial information involved.

49. Where the purpose is to illustrate the effect on assets and liabilities, the unadjusted financial information involved is usually a net assets statement or, sometimes, a statement of financial position. Where the purpose is to illustrate the effect on earnings, if not by way of a narrative description, the unadjusted financial information involved is usually a statement of profit or loss and other comprehensive income.

PD Regulation

ANNEX II Pro forma financial information building block

Item 2

In order to present pro forma financial information, a balance sheet and profit and loss account, and accompanying explanatory notes, depending on the circumstances may be included.

50. Where financial information that gives a true and fair view is available for an issuer, the issuer could choose to illustrate the effect of a transaction on all that information. However, it would be highly unusual for an issuer to prepare pro forma information comprising a complete set of financial statements. The provision of more than the primary financial statements could actually frustrate the purpose of the information and give a false impression of its reliability. Issuers should nonetheless consider whether the provision of additional pro forma financial information would serve a useful purpose and whether the selection of specific items for presentation could itself be misleading.

51. Annex I, Item 20.2 refers to the effect on assets and liabilities and it is practice to present a pro forma net assets statement. While Annex II, Item 2 refers to a balance sheet being presented it is usually the case that the impact of adjustments on the equity balances of the issuer is not significant to the purpose of the pro forma financial information or to an understanding of it.

52. Annex I, Item 20.2 also refers to the effect on earnings. It is general practice not to present a pro forma statement of profit or loss and other comprehensive income and, instead, issuers provide a narrative description of the effect on earnings. Notwithstanding this an issuer may decide that it would be helpful to investors to present a pro forma statement of profit or loss and other comprehensive income in an investment circular.

53. Pro forma financial information must give effect to a transaction as if the issuer had undertaken the transaction, in the case of a statement of profit or loss and other comprehensive income at the commencement of the period being reported on or, in the case of a pro forma statement of financial position or net assets statement, at the date being reported on.

54. A consequence of the requirement in the paragraph above is that a pro forma statement of financial position or net assets statement does not reflect the cumulative impact of pro forma statement of profit or loss and other comprehensive income adjustments. By way of example, it is appropriate to assume for the purposes of a pro forma statement of profit or loss and other comprehensive income that adjustments will be made on the basis that the proceeds of a share issue are received at the beginning of the period. The proceeds might then be applied to the repayment of debt so that interest costs are reduced. However, a pro forma statement of financial position at the end of the period will not reflect the benefits of reduced interest costs since, in preparing the pro forma statement of financial position, the issuer assumes that it only receives the proceeds at the statement of financial position date.

3.2.4 Presenting supplemental information

Pro forma financial information derived from the principal pro forma financial information

55. An issuer may present other pro forma financial information that is derived from the pro forma financial information presented to comply with the PD Regulation or the Listing Rules (the principal pro forma financial information). For example an issuer may make specific references to measures such as financial key performance indicators (KPIs) and regulatory ratios in the annual financial statements.

56. When illustrating the impact of pro forma adjustments on ratios and KPIs, the issuer should clearly explain those ratios and indicators and consider whether their presentation serves a useful purpose, is information that is publicly reported and is not misleading. The issuer should present the unadjusted financial ratios and KPIs and the pro forma financial ratios and KPIs on a consistent basis with the rest of the pro forma financial information. The source of information used for the unadjusted financial ratios and KPIs should be the same source as is used for the unadjusted financial information shown elsewhere in the principal pro forma financial information. The same considerations would apply to regulatory ratios such as those presented by financial services issuers.

Pro forma financial information not derived from the principal pro forma financial information

57. An issuer may decide to include other pro forma information to show the impact of the identified transactions on unadjusted financial information other than its principal unadjusted financial information used in the pro forma financial information presented to comply with the PD Regulation or the Listing Rules. This might be the case where an issuer routinely reports financial information externally under more than one basis, for example IFRS and local financial reporting standards. In these circumstances this additional set of pro forma financial information is presented on a standalone basis, distinct from the primary pro forma financial information and, therefore, separately complies with Annex II. An example of other pro forma financial information is embedded value pro forma information presented by issuers who undertake life assurance business and present supplemental embedded value financial statements as part of their routine external financial reporting.

58. Other pro forma financial information would be expected to be presented on a basis consistent with the presentation and policies adopted in presenting the unadjusted financial information. If the presentation of other pro forma information is more summarised than that of the principal pro forma financial information the description of the adjustments would still be expected to be sufficient to explain the constituent elements of each adjustment made.

3.2.5 Format of pro forma financial information

PD Regulation

ANNEX II Pro forma financial information building block

Item 3

Pro forma financial information must normally be presented in columnar format, composed of:

a) the historical unadjusted information;

b) the pro forma adjustments; and

c) the resulting pro forma financial information in the final column.

The sources of the pro forma financial information have to be stated and, if applicable, the financial statements of the acquired businesses or entities must be included in the prospectus.

59. An issuer prepares pro forma financial information for inclusion in an investment circular relating to a transaction by:

- presenting financial information that is included elsewhere in the investment circular or that has been previously published; and
- making adjustments to that financial information to illustrate how it might have been affected had the transaction occurred at an earlier date to which that financial information was prepared.

60. Annex I, Item 20.2 makes it clear that pro forma financial information is the result of adjusting the issuer's financial information at a specific date or for a particular period. Even though adjustments can be based on information at a different date or for a different period or related to subsequent Class 1 transactions, the result is still described as pro forma financial information at the date or for the period covered by the unadjusted source information of the issuer.

61. As required by Annex II, Item 3, pro forma financial information must normally be presented in columnar format where:

- the first column shows unadjusted financial information for the issuer on which the effect of one or more transactions is illustrated;
- subsequent columns reflect adjustments for the effect of the transaction or transactions. The issuer may aggregate adjustments to simplify the presentation so long as there is sufficient disclosure by way of note to explain clearly the components of each column and, where more than one transaction is involved, the separate effects of each transaction; and
- the final column displays the resultant adjusted amounts.

62. Annex II, Item 3 also includes the requirement to state the sources of the pro forma financial information. Accordingly, the source of the unadjusted financial information must be identified.

3.2.6 Accounting policies

PD Regulation

ANNEX II Pro forma financial information building block

Item 4

The pro forma information must be prepared in a manner consistent with the accounting policies adopted by the issuer in its last or next financial statements and shall identify the following:

a) the basis upon which it is prepared;

b) the source of each item of information and adjustment.

63. The policies adopted for pro forma financial information will be those in the unadjusted information.

64. The requirement to prepare the pro forma financial information in a manner consistent with the accounting policies adopted by the issuer in its financial statements does not preclude simplification of the presentation where such simplification assists in a clear reading of the pro forma financial information and is consistent with the specific purpose of the pro forma information. Furthermore, the format and purpose of the pro forma financial information mean that disclosures required by the issuer's applicable financial reporting framework which are supplementary to those contained in the primary financial statements do not normally form part of an issuer's pro forma financial information.

Application of acquirer's policies on an acquisition

65. The requirement to apply the issuer's accounting policies in preparing pro forma financial information applies to adjustments made in respect of an acquisition target. The Listing Rules require that for a Class 1 acquisition, historical financial information on an acquisition target is prepared in a form consistent with the accounting policies adopted by the issuer in its latest annual consolidated accounts. Generally this will take the form of restated financial information although, under certain conditions, the Listing Rules permit the target's historical record to be presented under the policies of the entity to be acquired together, if necessary, with a reconciliation to the policies of the issuer also being provided. The conditions (which, broadly, apply where the acquisition target is a publicly traded company) are set out in Listing Rule 13.5.27R. Although the Listing Rules do not prescribe the format of a reconciliation, the issuer will ensure that it includes any amounts that are relevant to the presentation of pro forma financial information.

66. Difficulties in presenting pro forma financial information are more likely to arise in contested bids when the directors of a proposed acquisition target choose not to recommend the issuer's offer to its shareholders and, in doing so, refuse or severely limit access to information relevant to the target.

67. In the UKLA Technical Note *Hostile Takeovers* (UKLA/TN/305.1), the FCA notes that

'We would not normally expect to see pro forma financial information included in a circular where an offeror does not have access to the relevant offeree information. This is because it is not normally possible for the reporting accountants to confirm …. that the information is compiled on a consistent basis with the accounting policies of the issuer.'

68. The requirement to prepare pro forma financial information on a consistent basis with the accounting policies of the issuer is exclusively the responsibility of the issuer, and it is the issuer's inability to obtain the evidence needed to prepare the pro forma financial information on the required basis that precludes its preparation. The UKLA Technical Note goes on to explain that, in these cases, the UKLA would expect the disclosure obligation to be addressed via a narrative description covering the expected effect of the takeover or merger on the earnings or assets and liabilities of the group rather than through the use of pro forma financial information.

3.2.7 Accounting periods

PD Regulation

ANNEX II Pro forma financial information building block

Item 5

Pro forma information may only be published in respect of

a) the current financial period;

b) the most recently completed financial period; and/or

c) the most recent interim period for which relevant unadjusted information has been or will be published or is being published in the same document.

69. Where a pro forma statement of profit or loss and other comprehensive income is presented for two or more entities or businesses, such as may be the case in a Class 1 acquisition, the unadjusted information about the issuer and the adjustments in respect of the other entity or entities should cover periods of the same length.

70. While desirable, it is not normally necessary to use coterminous accounting periods when preparing a pro forma statement of profit or loss and other comprehensive income for two or more entities or businesses. For example, an issuer may be preparing a pro forma statement of profit or loss and other comprehensive income based on its latest 31 December year end results for inclusion in a circular for a Class 1 acquisition. If a 12-month statement of profit or loss and other comprehensive income is only available for the business to be acquired up to 30 June prior to the latest 31 December year end, that information could generally be used for the purpose of making an adjustment to derive a pro forma statement of profit or loss and other comprehensive income.

71. Even where businesses are seasonal, the use of non-coterminous accounting periods would not usually distort a pro forma statement of profit or loss and other comprehensive income so long as all the information covers a complete year. Nevertheless, where pro forma interim financial information is presented and seasonal factors are significant, coterminous accounting periods may be required to prevent the pro forma financial information from being misleading.

72. Non-coterminous accounting periods may also be of concern when preparing pro forma net assets statements or statements of financial position. An issuer needs to consider any significant seasonal variations, or transactions between the respective balance sheet dates, that would cause the pro forma financial information to be misleading. In the situation of a Class 1 acquisition it might not be appropriate to make adjustments to an acquirer's 31 December information using information relating to the preceding 30 June for the acquired business, if it is known that seasonal factors would make the financial position of the acquired business significantly different at 31 December. The issuer should consider whether additional explanatory information would prevent the pro forma financial information from being misleading.

3.2.8 Subsequent events

73. Other than where a subsequent event qualifies as an adjusting event under International Accounting Standard (IAS) 10 *Events After the Reporting Period* and is reflected in the unadjusted financial information of the issuer or an acquisition target, it should not be reflected in pro forma financial information unless it qualifies to be reflected as an adjustment in accordance with the PD Regulation.

74. If an issuer believes that pro forma financial information would be misleading if it does not reflect significant non-adjusting events after the end of the reporting period which are relevant to an understanding of the matters addressed in the pro forma financial information given the purpose for which the pro forma financial information is being presented, it should consider whether adjustments to the pro forma or disclosure of the events in the notes to the pro forma financial information could be made which would prevent the pro forma financial information from being misleading.

75. It is practice to draw attention to the approach taken with regard to subsequent events by making a disclosure in the notes to pro forma financial information to the effect that it does not take account of any trading or transactions (other than those specified) subsequent to the date of the unadjusted information included in the pro forma information.

4. Adjustments

4.1 The nature of adjustments

4.1.1 General considerations

76. Issuers will need to determine which adjustments are necessary in order to illustrate the effect of the transaction for the purposes of the pro forma financial information. Annex II, Item 6 sets out the criteria for adjustments (reproduced below). Because, however, each adjustment contributes to the illustration presented, issuers should ensure that the adjustments that are necessary do not create an impression that is materially biased or one-sided.

77. In considering adjustments to illustrate the effect of a transaction, issuers should give consideration to the full effect of that transaction in the context of the illustration. For example, where the purpose of pro forma information is to show the potential effect of an acquisition on asset backing and profitability, it would be inconsistent and incomplete to include property, plant and equipment in a net assets statement at their fair values without reflecting depreciation charges based on those values in any pro forma statement of profit or loss and other comprehensive income information.

78. Similarly, it would be inconsistent and incomplete to illustrate an identified cost reduction without reflecting a consequential cost increase or revenue reduction. For example, where the proceeds of a share issue will be used to fund a debt repayment and this leads to a pro forma adjustment to reduce interest expense, the issuer should also reflect any related increase in its tax charge.

PD Regulation

ANNEX II Pro forma financial information building block

Item 4 (extract)

The pro forma information … shall identify … the source of each … adjustment.

Item 6

Pro forma adjustments related to the pro forma financial information must be:

a) clearly shown and explained;

b) directly attributable to the transaction;

c) factually supportable.

In addition, in respect of a pro forma profit and loss or cash flow statement, they must be clearly identified as to those expected to have a continuing impact on the issuer and those which are not.

ESMA Recommendations

ESMA Recommendations clarify certain terms used in Annex II Pro forma financial information building block. Relevant clarifications are reproduced together with the paragraph references in ESMA Recommendations.

'Factually supportable': the nature of the facts supporting an adjustment will vary according to the circumstances. Nevertheless, facts are expected to be capable of some reasonable degree of objective determination. Support might typically be provided by published accounts, management accounts, other financial information and valuations contained in the document, purchase and sale agreements and other agreements to the transaction covered by the prospectus. For instance, in relation to management accounts, the interim figures for an undertaking being acquired may be derived from the consolidation schedules underlying that undertaking's interim statements. (Paragraph 87)

'Directly attributable to transactions': Pro forma information should only reflect matters that are an integral part of the transactions which are described in the prospectus. In particular, pro forma financial information should not include adjustments which are dependent on actions to be taken once the current transactions have been completed, even where such actions are central to the issuer's purpose in entering into the transactions. (Paragraph 88)

4.1.2 Clearly shown and explained

79. It is important that issuers clearly show and explain adjustments so that investors can understand those adjustments. It is also a requirement to identify the source of the adjustment.

80. Disclosure of the adjustments will involve a combination of the columnar presentation and information presented in the notes. While having a separate column for each adjustment may be desirable in the interest of greatest transparency, there are practical constraints on the number of columns that can be presented in a conventional document format, and as a consequence, where there are more than a few potential individual adjustments, it is normal for the adjustment columns to contain information, with varying degrees of aggregation, reflecting more than one adjustment. In such cases, more detail of the basis for the aggregated numbers will be presented in the notes.

81. In respect of the adjustments, the column headings and/or the notes to the pro forma financial information will be designed to achieve a number of objectives, including:

- reference to the purposes of the adjustment;
- details of the sources of the amounts concerned (in some cases this may be achieved by referring to information set out elsewhere in the investment circular);
- where relevant, how adjustments have been aggregated or allocated to financial statement captions; and
- where relevant, where alternative outcomes are possible, confirmation of the basis adopted for the purposes of the pro forma financial information.

82. The level of detail provided in relation to the purpose of an adjustment may vary. In some cases, such as where the adjustment reflects the addition or subtraction of the net assets of the business to be acquired or disposed of, the purpose will be clear from the context and no further explanation will typically be given. In other cases, for example where the deal structure involves the retention of certain assets or liabilities, more detailed disclosure may be required of what the adjustment relates to.

83. The sources of the adjustment may be specifically identified by cross-reference, such as in the case of the financial information relating to a business to be acquired or disposed of. Alternatively information that is contained elsewhere in the investment circular may be repeated, for example details of the expected proceeds of the fundraising.

84. In some cases, adjustments presented may comprise the aggregate or net result of a number of adjustments. An example might be an adjustment to reflect the net proceeds of a fundraising, which is made up of the gross proceeds after deducting the costs of the fundraising. Disclosure of the two elements of the net figure would be made in the notes. Where proceeds are stated to be used in part to repay borrowings and in part for general corporate purposes, the note may explain how the apportionment between borrowings and cash has been determined.

85. Where the structure of a transaction provides a counterparty with an option, for example as to whether to receive consideration in the form of cash or shares, and it is not known at the time of the investment circular what decision the counterparty will make, the notes will describe how the existence of the choice has been dealt with for the purposes of the pro forma financial information (see Section 4.2.3).

4.1.3 Directly attributable to the transaction

86. The purpose of the requirement that adjustments are directly attributable to the transaction concerned is to prevent pro forma information reflecting matters that are not an integral part of the transaction which is described in the investment circular. In particular, pro forma financial information should not include adjustments which are dependent on actions to be taken once the transaction has been completed, even where such actions are central to the issuer's purpose in entering into the transaction, eg, eliminating duplicate facilities after an acquisition.

4.1.4 Factually supportable

87. In order to provide assurance as to the reliability of pro forma financial information, adjustments must be supported by facts. The nature of the facts supporting an adjustment will vary accordingly to the circumstances. Nevertheless, facts are expected to be capable of some reasonable degree of objective determination. Support might typically be provided by published accounts, other financial information and valuations contained in the investment circular, purchase and sale agreements and other agreements integral to the transaction covered by the investment circular.

4.1.5 Materiality

88. In considering which adjustments to make, issuers take into account the concept of materiality and focus on those adjustments which are material to the purpose of the illustration. Indeed, by making adjustments for immaterial items, directors may give a false impression of the precision and reliability of the resulting pro forma information and detract from disclosures they make under Annex II, Item 1 about the nature and limitations of the information. Nevertheless, issuers should bear in mind that the materiality of an item is determined not only by its size but also by the qualitative factors of its nature and circumstances.

4.1.6 Omitted adjustments

89. Issuers may be aware of the need to make an adjustment while lacking the appropriate factual support to satisfy Annex II, Item 6. In these circumstances, they should bear in mind the stated purpose of the related pro forma financial information and consider whether disclosing the omission of the adjustment will be sufficient to prevent the pro forma financial information from being misleading.

90. Where disclosure will not suffice, issuers should either make further efforts to obtain appropriate support or reconsider whether the proposed purpose of the pro forma financial information is realistic. Preparers of pro forma financial information should not lose sight of the fact that they are not obliged to publish pro forma financial information and, instead, may be able to fulfil the PD Regulation requirement by presenting a narrative description. This is particularly important where pro forma financial information may be misleading for reasons that are beyond the control of the preparer. As in other areas of financial reporting, there is sometimes a trade-off between the relevance and reliability of financial information. This may mean that an issuer does not report information that may be relevant because it is not sufficiently reliable.

4.1.7 Continuing effects

91. In respect of a pro forma statement of profit or loss and other comprehensive income, Annex II, Item 6 requires issuers to identify clearly those adjustments which are expected to have a continuing effect on the issuer and those which are not. An issuer is not permitted either:

    - to omit adjustments that are directly attributable to a transaction and factually supportable on the grounds that they do not have a continuing effect; or

    - to make adjustments to eliminate items solely on the grounds that they are considered not to have a continuing effect.

92. Ultimately, it is the responsibility of investors to make their own individual assessments of future earnings and cash flows. Consequently, it is recommended that an issuer interprets the requirement of Annex II, Item 6 in line with the requirements of IAS 1 *Presentation of Financial Statements,* IAS 7 *Statement of Cash Flows* and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* which cover appropriate disclosure of the results of continuing and discontinued operations and items of income or expense which are material. Adjustments related to discontinued operations will not have a continuing effect and should be disclosed as such. Other items should be considered on a case-by-case basis.

93. For the purposes of a pro forma statement of profit or loss and other comprehensive income, the relevant transaction is assumed to have been undertaken at the commencement of the period being reported on. As a consequence, it is normally necessary to regard costs attributable to the transaction as falling to be accounted for in the period to which the pro forma statement of profit or loss and other comprehensive income relates. Where such items affect the profit or loss and other comprehensive

income, it would be normal to identify them as items which will not have a continuing effect. If an issuer chooses to present pro forma statements of profit or loss and other comprehensive income for both the most recently completed financial year and the most recent interim period, even though such pro forma statements are not 'cumulative', it would not be meaningful to record the transaction costs in the pro forma statement for the interim period as well as in the pro forma statement for the most recently completed financial year.

4.2 Issues encountered in making adjustments

94. The paragraphs in Section 4.2 describe the application of Annex II, Item 6 to a number of items that frequently form the basis for adjustments in pro forma financial information.

4.2.1 Tax and similar effects

95. Issuers should consider the tax effects of adjustments directly attributable to a transaction, along with other non-discretionary effects, such as any material impact on profit-related bonuses. In quantifying tax effects, issuers should look at the incremental impact on tax liabilities and assets using their accounting policies for taxation rather than simply applying their overall effective tax rate.

4.2.2 Transaction costs

96. An adjustment should be made for costs directly attributable to a transaction that do not relate to future events or decisions and are factually supportable. Written estimates from advisers that are disclosed in total elsewhere in an investment circular will normally provide sufficient factual support.

4.2.3 Consideration in cash or shares

97. It may be necessary to make an assumption where there is choice as to the form in which consideration is received or paid. For example, in a public takeover, it may not be possible to determine in advance the extent to which a mixed cash and shares offer would be taken up in cash or shares. Consequently, an issuer will need to make an assumption as to the mix and state that assumption clearly. Any assumption that is made would be determined by the issuer in conjunction with its financial advisers and would need to represent an appropriate basis, given the stated purpose of the pro forma financial information. Where the actual outcome could differ materially from that reflected in the pro forma financial information this should be explained in the notes and, where possible, a quantitative indication of the possible impact on the pro forma financial information given.

98. Where the consideration for an acquisition will be settled by the issue of a specified number of shares it is necessary to determine which share price should be used to calculate the adjustment. In the subsequent financial statements it is most likely that the issue of shares will be recorded by reference to their value at the date of their issue. This value will not be known when the pro forma financial information is prepared. The most appropriate value to use is therefore the value at the most recently practicable date as this is the best indication of the effect of the transaction.

4.2.4 Contingent consideration

99. To the extent that consideration is payable or receivable in the future and is dependent on the outcome of future events, the issuer needs to make an appropriate assumption as to the most likely amount to be paid. This does not violate ESMA Recommendations (paragraph 88) on not making adjustments relating to future events provided it is consistent with the accounting policies of the acquiring entity. The need to make a best estimate of the amount of contingent consideration that is payable or receivable is a direct consequence of an acquisition or disposal. The relevant future events determine how accurate such an accounting estimate turns out to be but do not determine whether an estimate needs to be made. Where initial estimates are subject to significant subsequent changes, issuers will need to ensure that appropriate disclosure is made to investors.

100. It may appear prudent to assume that the maximum amount payable under an acquisition agreement will be paid or that the minimum amount receivable under a sale agreement will be received. However, the overriding requirement is to apply the accounting policies of the acquiring entity, which is likely to require that an appropriate estimate is made given the stated purpose of the pro forma financial information.

In circumstances where the impact of paying or receiving additional consideration could be significant a similar approach to that described in Section 4.2.3 should be adopted in dealing with such uncertainty.

4.2.5 Synergy benefits

101. It is often the case that acquisitions are justified in terms of the synergies to be obtained from bringing two businesses together, either through savings in costs or through enhanced cross-selling of products and services. Synergies are normally dependent on the future actions of the management of the enlarged group after completion of the transaction.

102. Consequently, synergies should not be the subject of adjustments made in deriving pro forma financial information, although it may be appropriate to indicate opportunities for synergy benefits elsewhere in the investment circular.

4.2.6 Cost and revenue eliminations

103. When considering an initial public offering or the bringing together of two or more businesses on an acquisition, it is sometimes possible to identify past costs or revenues that will not occur in future financial periods under the terms of the transaction. For example, levels of remuneration paid prior to an acquisition or initial public offering can be inconsistent with agreements entered into at the time of such transactions. While it may be reasonable to consider eliminating such costs as an adjustment in a pro forma statement of profit or loss and other comprehensive income, they will often need to be offset against increases in other costs which the issuer will incur that are not capable of being factually supported, for example increased corporate governance costs following an initial public offering. In such circumstances, issuers should disclose past costs or revenues which will not occur in future instead of eliminating them through pro forma adjustments. This could be done on the face of the pro forma statement of profit or loss and other comprehensive income or as a footnote.

4.2.7 Foreign currency translation

104. It may be necessary to translate adjustments into the reporting currency of the issuer. For a pro forma net assets statement or statement of financial position, the rate applied would usually be the rate ruling at the date of the issuer's unadjusted statement of financial position, even if the target statement of financial position has been drawn up to a different date. In these circumstances consideration should be given as to whether using the exchange rate at the date of the acquirer's statement of financial position could give rise to an anomalous result because, for example, significant assets and/or liabilities of the target were denominated in the reporting currency used by the acquirer and there had been significant movements in the relevant exchange rate between the respective statement of financial position dates. For a pro forma statement of profit or loss and other comprehensive income, the issuer would adopt its normal translation policy for subsidiaries. If the issuer uses an average rate, the rate applied for the purposes of making an adjustment would normally be calculated on the basis used by the issuer in preparing its unadjusted information for the relevant period.

105. Where the consideration for a transaction is denominated in a foreign currency, it would be usual to translate the adjustment relating to the consideration using the exchange rate at the most recently practicable date. Alternatively, if the consideration for the transaction has been fixed due to hedging arrangements, it would be appropriate to apply this rate and disclose the basis for the rate applied.

4.2.8 Debt repayment

106. The transaction that is the subject of the investment circular is frequently an issue of securities that will be used to repay debt. Issuers generally wish to present pro forma financial information to illustrate the potential effect of such transactions on gearing, interest cover and earnings. Questions that commonly arise in determining the relevant adjustments are:

- how to allocate the proceeds of the issue to the repayment of different debt instruments when insufficient funds will be raised to repay all debt; and, conversely
- how to treat any excess of the amount raised over the debt shown in the unadjusted financial information of the issuer; and

- how to determine the amount of the adjustment where the actual repayment is to be calculated by reference to an amount of debt at a particular date or is a fixed amount and this amount differs significantly from the amount of debt included in the unadjusted financial information that is used in preparing the pro forma financial information. Similar considerations arise where an amount of debt is being capitalised rather than being repaid.

107. Proceeds of the issue should be allocated to the repayment of debt instruments on the basis of commitments stated in the document or legal agreements existing at the date of the document which specify how the issuer will apply the proceeds. In rare circumstances where there are no stated commitments or legal agreements, the repayment of debt would not be directly attributable to the transaction that is the subject of the document. It would relate instead to future events or decisions and no consequential adjustment would be made to reduce debt balances or interest costs in the pro forma financial information.

108. Where the proceeds of an issue result in an increase in cash balances in a pro forma net assets statement or statement of financial position, it is normally inappropriate to make an adjustment to pro forma statement of profit or loss and other comprehensive income or earnings information to reflect interest or other income that cash balances might generate. This is because where management has discretion over how to use positive cash balances, any adjustment for interest or other income on those balances would not satisfy the requirement of Annex II, Item 6 that it be factually supportable and unrelated to future events or decisions. Exceptions would only arise where an issuer was committed to invest funds in a particular way which meant that it could demonstrate that income would be earned and could quantify it. This could arise, for example, where a financial institution is raising funds to meet capital adequacy requirements. Issuers should draw investors' attention to the pro forma statement of profit or loss and other comprehensive income treatment of issue proceeds where they consider it to be of particular significance in helping investors understand the issuer's prospects.

109. A transaction may be undertaken in order to reduce a debt balance to zero by repayment or capitalisation of the amount outstanding at the date of the transaction. For the purposes of pro forma financial information illustrating the effect of that transaction, the amount of debt included in the unadjusted financial information may differ significantly from the amount that will be repaid or capitalised as a result of the transaction. This may occur due to other transactions, including normal trading, that have taken place since the unadjusted financial information date and are therefore not reflected in such financial information. The principle that adjustments need to be factually supportable means that the adjustment that is made is based upon the actual amount that is expected to be repaid or capitalised. In the case of a pro forma net assets statement, this may result in the pro forma financial information containing a residual debt balance, or an excess cash balance, according to whether the balance in the unadjusted financial information is greater than or less than the relevant amount for the purpose of the transaction. The issuer should consider whether additional disclosure that clearly explains the link between the historical unadjusted information, those subsequent transactions which are not reflected in the pro forma, the use of proceeds as disclosed in the investment circular and the resultant pro forma position, would prevent the pro forma financial information from being misleading.

110. It is not appropriate for the pro forma financial information to seek to introduce adjustments that are not directly attributable to the transaction (such as subsequent movements in balances shown in the unadjusted financial information) nor to introduce hypothetical transactions (such as additional payments) as if the objective of the pro forma financial information were to illustrate the resultant financial position of the company rather than to illustrate the effect of the actual transaction on a hypothetical basis ie, as if it had occurred at an earlier date. Where relevant, the inclusion of additional disclosure may be appropriate - for example to explain that the resultant debt balance will not be indicative of the balance that would be reported immediately subsequent to the transaction taking place. As in all cases, consideration needs to be given to whether, notwithstanding the disclosures made, the pro forma financial information may nevertheless be misleading.

4.2.9 Fair values

111. An issuer using IFRSs that enters into a business combination will need, as a direct consequence of the transaction, to ascertain the fair values of the underlying assets and liabilities of the business that is treated as the acquired entity in accordance with IFRS 3 *Business Combinations* and IFRS 13 *Fair Value Measurement*. However, the extent of factual support for potential fair value adjustments will often be a key issue in determining whether an issuer can reflect them in pro forma financial information. Factual support may be provided through formal valuations which the issuer commissions or carries out either for commercial purposes or to satisfy other regulatory requirements in respect of the investment circular.

112. To ensure that pro forma financial information is not misleading, issuers should weigh the following factors when considering whether they need to record fair value adjustments:

- the nature of the acquisition and its commercial justification (eg, there is an expectation that asset-based deals would be more likely to require fair value adjustments than those involving significant amounts of goodwill);

- the extent to which uncertainties regarding fair values are commercially addressed through warranties, indemnities or adjustments to the purchase consideration (eg, the fair valuation of environmental liabilities or pension surpluses might not be significant for a pro forma net assets statement if any fair value adjustments are compensated by changes in the consideration paid by the issuer);

- the stated purpose of the pro forma financial information and the consequential significance of any misallocation of the purchase consideration between, on the one hand, assets and liabilities that would be subject to a fair valuation exercise and subsequent amortisation and, on the other hand, goodwill. This might be particularly significant if a pro forma statement of profit or loss and other comprehensive income were being presented;

- the likely materiality of fair value adjustments based upon the issuer's investment appraisal and acquisition due diligence; and

- any other matters elsewhere in the investment circular that have been brought to the attention of investors and which indicate that a fair value adjustment might be material.

113. Where it has been decided that adjustments will be made to reflect fair values, consideration needs to be given as to how to obtain relevant information on which to base the adjustments. For the purpose of preparing future financial statements reflecting the actual transaction, fair values will be determined initially at the effective date of the acquisition and may then be subject to further revision. At the time of preparation of the pro forma financial information such fair values will not have been determined and any estimates of these future values are unlikely to be factually supportable. For the purposes of pro forma financial information therefore, the issuer will need to consider whether there is factually supportable information relating to fair values that will be suitable as a basis for an adjustment.

114. Where such factually supportable information is available for more than one date, it will generally be appropriate to use the most recently available information on the basis that this is likely to be most indicative of the actual fair value adjustments that will be made. Where such information is only available at an earlier date (for example where an independent property valuation had been carried out at the target's balance sheet date), it may be acceptable to make adjustments based upon that information provided that there is no evidence to suggest that there had been a change subsequent to that date such that its use would cause the pro forma financial information to be misleading.

115. A potential consequence of using valuations as at dates subsequent to the target's balance sheet date is that they may relate to assets and liabilities that are different from those reflected in that balance sheet. For example, assets may have been acquired or disposed of since the balance sheet date. Where such acquisitions or disposals are not directly attributable to the transaction, they will not have been reflected as adjustments in the pro forma financial information. As the objective of the pro forma financial information is to demonstrate the effects of a specific transaction, in such circumstances consideration should be given as to whether the proposed adjustment is likely to be indicative of the actual fair value adjustment that will subsequently be made. If it is concluded that this

is not, or that it is unlikely to be the case, consideration should be given as to whether a further adjustment can be made and/or disclosure included to rectify this if it is material to an understanding of the pro forma financial information.

116. Where issuers judge that fair value adjustments are unlikely to be material in the context of the stated purpose of pro forma financial information, such adjustments are not necessary. For example, where a pro forma net assets statement is intended to illustrate the impact of an acquisition on gearing, as opposed to tangible net assets per share, then any misallocation of the purchase consideration between goodwill and a fair value adjustment on properties is unlikely to be significant. In such a case, issuers should make appropriate disclosure in the notes to the pro forma financial information. In other circumstances, issuers may need to record fair value adjustments, supported, as appropriate, by note disclosure of their provisional nature and any related uncertainties and contingencies.

4.2.10 When the issuer is a Newco

117. In some instances a transaction may involve an issuer which is a newly incorporated holding company (Newco), created as the new parent company of an existing trading company or group (Oldco). As a consequence, in accordance with Article 4a of the PD Regulation, the investment circular will usually be required to include relevant financial information relating to Oldco. The PD Regulation notes that such information shall be deemed to relate to the issuer. Where the Newco has not traded or entered into any transactions since incorporation, issuers will generally not be required to prepare any financial information in relation to Newco for inclusion in an investment circular. Instead, the investment circular will usually include a statement that Newco has not traded or entered into any transactions since incorporation. Issuers may also include a statement that no financial information for Newco has been audited.

118. Where, in the context of such a transaction, issuers elect to include pro forma financial information in the investment circular to illustrate the effect of a significant gross change such as a fund raising or an acquisition, in presenting unadjusted information, they may present Oldco's financial information where Newco has not traded or entered into any transactions since incorporation.

4.2.11 Reflecting other small transactions

119. As a matter of general principle, issuers should not make adjustments for transactions which are not the subject of the pro forma financial information. The requirement that the resulting information is not misleading precludes cherry-picking transactions for which adjustments are made.

120. Issuers may wish to make adjustments to reflect other transactions which have taken place since the latest statement of financial position date but which would not be classified independently as a significant gross change or did not require a document such as a prospectus or a Class 1 circular. Issuers will consider the purpose of the information and the need for the information not to be misleading in deciding whether to make adjustments for other small transactions.

APPENDIX: LIST OF ABBREVIATIONS

ESMA	European Securities and Markets Authority
FCA	Financial Conduct Authority
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standard
ICAEW	Institute of Chartered Accountants in England and Wales
IFRS	International Financial Reporting Standard
ISAE	International Standard on Assurance Engagements
LSE	London Stock Exchange
PD Regulation	Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing the Prospectus Directive
SIR	Standard for Investment Reporting (published by the UK Financial Reporting Council)
TECH 18/98	ICAEW Technical Release TECH 18/98, *Pro Forma Financial Information, Guidance for Preparers under the Listing Rules*
UKLA	The United Kingdom Listing Authority, the UK securities regulator and part of the FCA

ANNEX 1: WORKING GROUP MEMBERS

Robert Hodgkinson, Chairman	ICAEW
Anne Brisbin	PwC
David Cattermole	KPMG
John Chapman	Baker Tilly
Steve Hextall	EY
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Sue Nyman	Grant Thornton
Chris Searle	BDO
Toby Tinniswood	Deloitte

ANNEX 2: MARKET FEEDBACK

Pre-consultation of market participants

The Working Group identified market participants whose views would influence the decision to update the guidance in TECH 18/98 *Pro forma financial information, Guidance for preparers under the Listing Rules*. In a series of meetings in 2012 the Working Group consulted the parties listed below to identify challenges in meeting the requirements for preparing and presenting pro forma financial information:

Association for Financial Markets in Europe

Central Bank of Ireland

Chairman of the City of London Law Society Company Law Committee

European Securities and Markets Authority

Chairman of the SIRs Committee of the UK's Auditing Practices Board

United Kingdom Listing Authority

Invitation to comment on the Status Report

ICAEW published *Pro forma financial information, Status Report on updating guidance for directors* (the Status Report) in May 2013. Following its publication and before finalising the exposure draft of new guidance the Working Group held further meetings with market participants and considered written comments on the Status Report. Written comments received are available to view on the ICAEW website at icaew.com/financingchange.

We are grateful to all those who provided comments.

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 140,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

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