FINANCIAL CONDUCT AUTHORITY

Technical Note

Profit forecasts and estimates

ESMA update of the CESR Recommendations (subsection II. 4); PR Appendix 3 Annex 1 item 13; LR 13.5.32R

Definition of a Profit Forecast

PR Appendix 3 Annex 1 item 13 (and similar Annex items, which replicate the requirements set out in the Annexes of Commission Regulation 809/2004/EC); LR 13.5.32R; ESMA update of the CESR Recommendations (subsection II. 4)

The requirements on profit forecasts and estimates are set out in PR Appendix 3 Annex I 13.1 – 13.4 (and similar Annex items), the ESMA update of the CESR recommendations (subsection II. 4), ESMA's Q&A on Prospectuses (Q25) and LR 13.5.32R – 13.5.34G (for Class 1 acquisitions). Both the Listing Rules and Prospectus Rules incorporate the Prospectus Regulation definition of a profit forecast, which is: 'Profit Forecast – a form of words which expressly states or by implication indicates a figure or a minimum or maximum figure for the likely level of profits or losses for the current financial period and/or financial periods subsequent to that period or contains data from which a calculation of such a figure for future profits or losses may be made, even if no particular figure is mentioned and the word "profit" is not used'. In addition, the ESMA recommendations provide issuers with some broad guidance on how they could determine whether or not they have made a profit forecast for the purposes of a prospectus.

Companies should bear in mind the requirements referred to above when making any public announcement that contains statements about their future performance. LR 13.5.33R requires (for class 1 circulars) the company to include in the circular any profit forecasts or estimates published before the class 1 transaction and either (a) comply with the requirements in LR 13.5.32R, or (b) explain both why the forecast or estimate is no longer valid and why reassessment is not necessary. For prospectuses, PR Appendix 3 Annex 1 13.4 (and similar Annex items) requires the issuer to include a statement on whether or not an outstanding forecast or estimate is still valid, with an explanation of why it is not if that is the case. Issuers should make sure that any statement they publish about their future performance is not a forecast if it is not intended to be one. Often, statements made by companies in previous announcements are caught by the profit forecast requirements when the companies come to prepare prospectuses or class 1 circulars.

In practice this covers a broad range of statements of future performance. In particular it should be noted that the definition covers statements about 'losses' as well as about 'profits', and that neither word needs to be used at all. For example, where the words 'results' or 'earnings' are used, the FCA may still take the view that there is a forecast or estimate if it is apparent that the market interprets this as profit. It is also possible, depending on the context, that a forecast of earnings per share will be viewed as a profit forecast. Revenue figures may also be a profit forecast if that allows a calculation of profit. This is most likely to be the case where an issuer has previously published details of its profit margins.

Statements of performance against market expectations may also be forecasts if there is a clear market consensus of expectation that allows a calculation of a floor or ceiling on forecast profits.

It should also be noted that the definition refers to a 'financial period', and not to a reporting period or other defined length of time. So it is possible that a comment limited to a quarter/half year may be still construed as a forecast.

It is also worth noting that in a class 1 acquisition situation, a forecast made before the class 1 transaction relating to the target (or a significant part of the target) must, under 13.5.33R, be included in the circular. The company must also (a) comply with the requirements in LR 13.5.32R in relation to the forecast or estimate, or (b) explain both why it is no longer valid and why reassessment is not necessary.

Basis on which profit forecasts are prepared

Paragraph 47 of the ESMA recommendations states that a profit forecast should normally reflect profit before tax (with separate disclosure regarding any non-recurrent items and tax charges if these are expected to be abnormally high or low). More importantly, the ESMA recommendations indicates that, where a forecast is made on any basis other than profit before tax, the reasons for presenting another profit line (such as operating profit or EBITDA) must be disclosed and clearly explained. We reiterate that we would expect issuers to clearly outline the reasons for presenting forecast figures on a basis other than profit before tax. The premise behind this requirement is that it provides shareholders with the ability to compare the forecast with an issuer's published results.

Invalid profit forecasts and estimates

The regulatory requirements in relation to outstanding profit forecasts or estimates in connection with class 1 circulars and prospectuses are referred to above.

In some cases, issuers and their advisers may state that previously made profit forecasts and estimates are no longer valid, and hence avoid the requirement to state assumptions and, in the case of a prospectus, to have an accountant report on the forecast.

However, this approach is only appropriate when the previously made forecast is rendered invalid or inaccurate due to matters not contemplated in the original forecast, and should not be used by issuers as a way to avoid these requirements.

To make the assertion that a previously made profit forecast is invalid, an issuer needs to demonstrate that changes have occurred since the date the forecast was made, which were not taken into account in the forecast and mean that the actual profits or losses will likely be materially different from those forecast. Frequently these changes relate to an acquisition (or occasionally a disposal) in contemplation (usually the subject of the documents), and the reasons for invalidity relate to differences in circumstances between when the forecasts were made, and the likely position of the issuer or target following the transaction.

In determining whether the reasons for invalidity are credible, we will take into account the following:

- **When was the forecast made:** We will take into account when the profit forecast was made, and whether the transaction was in contemplation at that time. A profit forecast made several months before an acquisition is announced is more likely to be no longer valid than one published post-announcement.
- **Materiality:** Reasons for the forecast's invalidity should be expected to have a material impact, either individually or in aggregate. Immaterial reasons should be avoided so investors understand the key reasons for invalidity. An issuer should not present generic factors that are not materially relevant to the forecast. Also, it is important that the stated reasons have a material impact during the remaining part of the forecast period – e.g. synergies are less likely to be seen as a valid reason if the acquisition is only going to complete close to the end of the period.
- **Factors considered as a whole:** We are likely to consider all of the reasons presented as a whole, taking into account the specific circumstances of the issuer and the profit forecast in question.

Specific examples of reasons given for invalidity

We present below a selection of typical factors that we have seen, together with some considerations on when they are more or less likely to be credible reasons for invalidity. The list is not necessarily exhaustive, nor should it be taken that these reasons will always be accepted, as we will assess each case on its own merits. It should not be assumed that just because a reason for invalidity is accepted in a particular case that it will apply in all circumstances.

- **Synergy benefits** anticipated in an acquisition that were not included in issuer or target profit forecasts. This reason is more credible when synergies/quantified financial benefits are extensively discussed in the transaction documents.
- **Restructuring/integration costs** expected for an acquisition that were not included in the issuer or target profit forecast.

- **Divestments** expected for an acquisition that have not been considered within the issuer or target profit forecast. This is more likely to be accepted when these are due to enforced disposals following reviews by competition authorities. Expected voluntary divestments by the enlarged group for strategic reasons are less likely to be sufficiently evidenced at the point of publication of the document to justify invalidity of the profit forecast.
- **Purchase price allocation adjustments** expected to be made to a target not considered in target's profit forecast. For example the PPA exercise may lead to an increase in intangible assets subject to amortisation, and this would potentially lead to lower profits in the target than previously forecast.
- **Transaction costs** that have not been considered in the issuer's (or target's) profit forecast. Care should be taken if these transaction costs are clearly quantifiable, e.g. from the prospectus.
- **Foreign exchange** movements since the forecast was made might be significant enough reasons for invalidity if for example the issuer has overseas subsidiaries or material revenues/costs in foreign currencies.
- **Events in the period between the date** the profit forecast was originally made and the date of the document. Specific events in this period that were unanticipated in the profit forecast may be sufficiently material to be a reason for invalidity. Such events should be explained in the narrative. A general reference to changes in 'assumptions and estimates' is less likely to be sufficient to justify, on its own, that a profit forecast is invalid. Events that have led to announcements/disclosure in interims are more likely to be seen as sufficiently material.
- Change in **accounting framework ('GAAP')** or accounting policies to align financial reporting basis of target and issuer. It may be that material GAAP differences could be citied as a reason for invalidity. However any references to changes in GAAP or changes in accounting policies should explain what specific impact of the changes is likely to be on the operating performance and profit forecast of the target or issuer, as applicable. Noting that there is going to be a change in GAAP, or that there is a risk that there may be differences in accounting policies, without explaining the specific differences, is unlikely to be sufficient to justify invalidity of a profit forecast.
- Change in **presentational currency** by a target to align with issuer's presentational currency that was not addressed in the issuer or target profit forecast. An expected change in the presentational currency of a profit forecast is unlikely to be sufficient to justify invalidity of the profit forecast, as the conversion of the profit forecast in the original presentational currency into the new presentational currency does not impact the expected underlying performance projected in the profit forecast.

- **Issuer may take different strategic/operating decisions** compared to those assumed by target when preparing target's standalone profit forecast. Expected changes in the strategic direction or operating decisions made in relation to the target by the new management team are less likely to be sufficient to justify invalidity of target's existing profit forecast on their own without other reasons supporting the invalidity. It may be the case that these changes can be factually supported through details of the change in strategic direction being disclosed elsewhere in the document.

- **Period covered by profit forecast is longer than 12 months.** Long-term profit projections, such as annual projections across a five-year period, can be caught by the definition of a profit forecast in Article 2(10) of the PD Regulation; therefore all years in such a profit forecast should be addressed in accordance with Annex I item 13.

  We are aware that this differs from the Takeover Panel's approach, in which Rule 28.2 of the Takeover Code explains that the Panel will normally dispense with the requirement for reports from accountants and financial advisers for periods ending more than 15 months from when the forecast was first published.

  However, the longer term nature of forecasts for periods of longer than 12 months may mean that other reasons for invalidity (such as those mentioned here) are more credible. There may be situations where the first year of a profit forecast is treated in accordance with Annex I, items 13.1 to 13.3, but later years (e.g. years 2–5) are viewed as invalid and an explanatory statement in accordance with Annex I, item 13.4 is disclosed.

- Change in **tax and capital structure** following the transaction might be credible reasons for invalidity, provided that the profit forecast relates to a profit metric that takes tax and interest into account. EBITDA is unlikely to be affected by changes to future tax and interest payments.

- On occasions, the **profit forecasts have been made due to the requirements of another regulator.** The most common situation is where forecasts have been included in an offer document at the request of an overseas takeover regulator. These forecasts may be included to support a valuation or a fair and reasonable opinion/recommendation. We have been presented with arguments that these forecasts have not been made by the issuer, or that the issuer has had no involvement in their preparation. We would consider these types of arguments to be less credible, however, because these offer documents are often presented as joint documents of the issuer and target, and the inclusion of a forecast in a document with the issuer's name on the front cover leads to a presumption that the forecast has been implicitly endorsed by the issuer. In these cases, issuers may still present other arguments to support the invalidity of the forecast, if applicable.