Annex 1 item 20.2 of Appendix 3 of the Prospectus Rules requires, 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. The requirement will normally be satisfied by the inclusion of pro forma financial information, the presentation and content of which is set out in Annex 2 of PR Appendix 3.

What is a ‘significant gross change’?

Article 4a(6) and Recital 9 of the PD Regulation (reproduced at PR 2.3.1) define 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. Accordingly, if a prospectus is prepared in connection with a class 1 transaction by a premium listed issuer, there is a significant gross change. Similarly, a prospectus for a standard listed (or unlisted) issuer to raise funds for an acquisition that would have been classified as class 1 if the issuer had been premium listed would need to address the significant gross change.

While a significant gross change could be directly related to the production of the prospectus, this is not necessarily the case.

A significant gross change may result from a transaction which is not, in itself, the subject of the prospectus.

A significant gross change transaction also covers situations where the transaction has not yet taken place but where the issuer has made a ‘significant firm commitment’ (ESMA Q&A 50 Aa). Despite the differing terminology, the effect of Article 4a(5) of the PD Regulation is that ‘significant financial commitment’ is the same thing as a ‘significant firm commitment’.

We would consider that a pure fundraising transaction (eg, a large rights issue or an open offer) would not constitute a significant gross change transaction for the purposes of Annex 1 item 20.2. However, if a fundraising is undertaken in connection with an acquisition, the related acquisition might, depending on its size, constitute a significant gross change.

What information does Annex 2 apply to?

For the purposes of identifying information in a prospectus to which the requirements of Annex 2 must apply, put simply, it is any information which includes a figure c which has been calculated by way of the formula ‘a+b=c’, where:

1 Such requirement is also triggered by Annex 23 item 15.2 and Annex 25 item 20.2 of PR Appendix 3. For ease of reference, only Annex 1 item 20.2 will be mentioned for the purpose of discussion in this note.
• a is the historical financial information;
• b is the hypothetical adjustment (typically a transaction or change, for balance sheet purposes, that had not happened as at the date of a or, for income statement purposes, during the full period covered by a); and
• c is the resultant pro forma information.

Financial information where no hypothetical adjustment has been made (eg where it has simply been prepared on a different basis from the audited financial information) is not considered as being pro forma financial information for the purposes of Annex 2.

The requirement for a pro forma profit and loss account

Once a significant gross change has been identified, Annex 1 item 20.2 states that the prospectus must 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 will normally be satisfied by the inclusion of pro forma financial information.’

Annex 2 item 2 states that:

‘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.’

We do not consider that Annex 2 should be regarded as mandating the production of any or all of these items of pro forma financial information, but rather as describing the way in which pro forma financial information should be presented and the information which must be included.

In ESMA Q&A 50 it is made clear that a narrative description of the impact on earnings or assets and liabilities will not normally be acceptable unless the inclusion of pro forma information:

• is not feasible (eg, if the issuer cannot gain access to the relevant information with reasonable effort, for example in a hostile takeover); or
• might not be a fair way to describe the effect of the transaction.

As such, we would expect a pro forma profit and loss account (P&L) to be presented in addition to a pro forma balance sheet and accompanying explanatory notes. In certain circumstances, a balance sheet and/or P&L may not be required if the impact of the significant gross change is already reflected in the issuer’s published financial statements (as discussed further in ESMA Q&A 51).

‘Voluntary’ pro forma financial information – ie, where there is no significant gross change or where Annex 1 item 20.2 does not apply

When an issuer includes a pro forma balance sheet in a prospectus but there has not been a significant gross change for the purposes of Annex 1 item 20.2 (for example, to illustrate the proceeds of an offering to be received by the issuer), we consider that this is not subject to Annex 1 item 20.2 because we consider this to be voluntary pro forma financial information. Similarly, if Annex 1 item 20.2 does not apply to an issue (for example, in the case of an issue of debt securities) then we would also consider any pro forma balance sheet included in the prospectus as being voluntary pro forma financial information.
We consider that this voluntary pro forma financial information would be subject only to the requirements of Annex 2 (as discussed in ESMA Q&A 54). Annex 1 dictates when an issuer must prepare pro forma financial information. Annex 2 explains how pro forma financial information should be presented and the information which must be included, whether as a consequence of being required by Annex 1 or due to being included voluntarily.

We consider that there is no requirement to include a pro forma P&L in circumstances where there is no significant gross change or where Annex 1 item 20.2 does not apply to the issuer.

However, for voluntary pro forma information presented by the issuer (regardless of whether it is a balance sheet or P&L), ESMA Q&A 54 requires such information to be prepared with the same level of care as when it is mandatory, and for it to be prepared and included in the prospectus following the requirements set out in Annex 2.

**Class 1 circulars – effect on LR 13.4.1R(5)**

Market practice for class 1 circulars has been to include a pro forma balance sheet and a narrative statement on earnings. Notwithstanding the revised approach taken by ESMA with regard to significant gross changes for prospectuses, we would not expect this practice to change for class 1 circulars. However, we would highlight that if a prospectus is being produced in connection with the same transaction then, in relation to the prospectus, Annex 1 item 20.2 will apply in full.

**Illustrative examples of pro forma P&L**

We illustrate below with two example cases. In both cases a prospectus subject to Annex 1 item 20.2 is being prepared in year N and one significant gross change has occurred which is not the trigger for the document (eg, the prospectus relates to a fundraising which is not, in itself, a significant gross change). The difference however is that in Case A the transaction resulting in the significant gross change is occurring in the financial year in which the prospectus is being prepared, whereas in Case B the transaction resulting in the significant gross change took place in the financial year prior to that in which the prospectus is being prepared.

In Case A, a pro forma P&L for the period ended 31 December N-1 would be required as if the transaction had happened on 1 January N-1, ie, the commencement of the period being reported, to reflect its impact on earnings for the full period. A pro forma balance sheet as at 31 December N-1 is also required to reflect the impact on assets and liabilities from the transaction at that date.
In Case B, a pro forma P&L for the period ended 31 December N-1 would be required as if the transaction had happened on 1 January N-1 as its impact on earnings has not been reflected for the full period. A pro forma balance sheet is not required as the impact on assets and liabilities from the transaction would have already been reflected in the balance sheet of the most recent completed financial statements (as at 31 December N-1).

The preparation of a pro forma P&L

As income statement information spans a period of time, a pro forma P&L needs to demonstrate the impact on earnings since the beginning of the financial period, whereas a pro forma balance sheet only needs to demonstrate the impact on assets and liabilities at the end of the financial period. Therefore, the preparation of a pro forma P&L can often be more complicated than that of a pro forma balance sheet.

In a Q&A format below, we address a number of issues that might be encountered in the preparation of a pro forma P&L.

1. Should source financial information always appear in the prospectus?

   Annex 2 item 3 states: ‘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.’

   Therefore, if the acquired business has published financial statements then they will be required to be included in the document. In many cases the financial statements of the acquired business will already be part of the prospectus, having been included as a result of the complex financial history requirements as set out in Article 4a of the PD Regulation (reproduced in PR 2.3.1) or will otherwise be available, for example as part of the class 1 circular disclosures made by a premium listed company.

   Where there are no such financial statements that could be included in the prospectus then the “if applicable” test within Annex 2 item 3 would not be satisfied. This test should not be regarded as imposing a further requirement for the production of financial statements.

2. Does the source financial information need to be audited?

   There is no requirement resulting from Annex 2 itself for the source financial information to be audited.

   However, as noted above it is likely that, in certain situations where there has been a significant gross change, an issuer will have audited financial information available, for example as a result of the need to include additional financial information to meet the complex financial history requirements as set out in Article 4a of the PD Regulation (reproduced in PR 2.3.1). In particular, depending on the size of the acquired entity, the
presence of audited source financial information for an adjustment may be sufficient to address the complex financial information requirements.

For example, in Case A above, where the ‘significant gross change’ transaction also occurred in year N, the complex financial history requirements could result in the inclusion of audited financial statements of the target(s) for year N-1 in the prospectus.

3. **If the target has no financial statements, would they need to be prepared specifically for the document?**

If financial statements are not available, we would accept the pro forma adjustments being sourced from unaudited financial information on the target(s), such as management accounts. We do not envisage requiring the production of financial statements purely for the purposes of the pro forma financial information.

It should be noted that, depending on size of the transaction, audited financial information may still need to be included in the prospectus for this period under the complex financial history provisions as discussed in 2, above.

4. **What approach may be taken in presenting a pro forma P&L for an acquisition that occurred in year N-1?**

For acquisitions such as Case B above, where the target’s historical financial information was partially consolidated in the issuer’s latest annual accounts, we consider that two alternative approaches could be used to demonstrate the impact on earnings.

Both approaches assume that the issuer’s historical consolidated financial information (including the partially consolidated target information) is presented as the unadjusted information in the first column of the pro forma P&L.

We consider that the pro forma P&L could be prepared by:

- subtracting the partially consolidated target financial information and then adding the target’s latest full year financial information to those of the issuer through separate adjustment columns of the pro forma P&L or
- presenting the target financial information only for the pre-acquisition period in the adjustment column.

We would accept both approaches.

5. **Can the accounting exercise of purchase price allocations (PPAs) be viewed as ‘factually supportable’ and included as pro forma adjustments?**

The accounting exercise of purchase price allocation to fixed assets at fair value and the subsequent amortisation or impairment of those assets very often requires a degree of judgement and the use of assumptions.

We consider that PPAs are ‘factually supportable’ as required by Annex 2 item 6(c) and would expect to allow these as pro forma adjustments if the issuer:

- sets out in the explanatory notes the basis adopted in making the PPAs;
- specifies any assumptions used; and
• where relevant, quotes any relevant supporting evidence.

Where a PPA is preliminary, we expect issuers to disclose this fact together with what events are expected to occur to complete the exercise and the potential impact of any reallocation.

6. Can synergy benefits be included as pro forma adjustments?

By contrast, we consider that synergy benefits are dependent on future actions of management of the enlarged group after completion of the transaction. We consider that synergy benefits are not directly attributable to the transaction, as required by Annex 2 item 6(b), and that accordingly they should not constitute pro forma adjustments.

7. What is the time period that needs to be covered by pro forma financial information, in particular, would a six-month pro forma P&L be acceptable?

ESMA stated through Q&A 51 that a period of six months is generally sufficient to describe how the transaction might have affected the earnings of the issuer. However, there may be situations where the time period should be longer, for example where the issuer’s business is affected by seasonality. The decision about the time period should always include consideration of the circumstances on a case-by-case basis.

For example, if the prospectus in Case B above is being prepared in the second half of year N (rather than in the first half of year N) and the issuer has published its interim financial statements, no pro forma P&L would be necessary as the earnings impact of the transaction is already reflected in the interim financial statements for year N, unless in the circumstances of the case a longer time period would be required.

The report prepared by independent accountants

Any pro forma financial information included in a prospectus (whether or not there has been a significant gross change) must be prepared in accordance with Annex 2, including item 7. ESMA Q&A 54 is clear that this includes an accountant’s report.

The typical SIR 4000 report used in the UK to report on pro forma financial information generally refers to the report being required by Annex 1 item 20.2. However, in the case of voluntary pro forma financial information, we consider that it is not appropriate to refer to this item, since this implies there has been a significant gross change. Instead, we consider that reference should be made to Annex 2 item 7 (the item which refers to an accountant’s report).

Where historical financial information (annual or interim financial information) included in a prospectus itself includes pro forma financial information in order to comply with the applicable accounting framework (usually IFRS), we would not expect additional disclosure to be included to address Annex 2. However, if the pro forma financial information relates to a significant gross change, and Annex 1 applies to the issuer, then Annex 1 item 20.2 will need to be addressed.