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Pro formas – explaining the financial impact of a significant gross change to a business in DCM offering documents

This note is written in the context of DCM bond issues in the European market, which are being offered to professional investors and under an exemption to the registration requirements of the US Securities Act of 1933, as amended, on either a Regulation S or a Rule 144A/Regulation S basis. It is therefore a high level overview of a complex topic, intended to provide a general overview of the issues. Prior to taking any specific actions, the particular factual circumstances of an individual bond issue and issuer should be considered and specific legal advice sought.

What is pro forma financial information?

Pro forma financial information is a hypothetical illustration of the effect of a transaction on an issuer's assets and liabilities, and/or earnings. It is hypothetical as it assumes that the transaction had been undertaken at the commencement of the period being reported on (in the case of a profit and loss account) or as of the date being reported on (in the case of a balance sheet).

Where the financial impact of a transaction has not been fully reflected in the most recent period covered by the issuer's historical financial information, the issuer's historical financial information is adjusted for the hypothetical impact of the transaction, to generate the pro forma financial information.

Historical financial information + Hypothetical adjustment = Pro forma financial information

Is there a UK/EU regulatory requirement to include pro forma financial information in DCM offering documents?

There is no explicit UK or EU regulatory requirement to include pro forma financial information in a debt capital markets offering document. When a prospectus pursuant to the EU Prospectus Regulation or the UK Prospectus Regulation is required for an equity security, pro forma financial information is only required where there has been a "significant gross change" (Item 18.4, Annex 1, Commission Delegated Regulation (EU) 2019/980, and the equivalent UK onshored version of this regulation (the **EU/UK PR Delegated Regulation**)). There is no equivalent requirement in the EU/UK PR Delegated Regulation for debt securities.

Therefore in the DCM context, regardless of whether bonds are to be listed on a regulated or an exchange-regulated market, pro forma financial information would only ever be included in an offering document on a voluntary basis. Why would an issuer voluntarily include pro forma financial information in its DCM offering document? An issuer would do so to satisfy its general disclosure obligation to include "all necessary information which is material to an investor for making an informed assessment of: (a) the assets and liabilities, profits and losses, financial position, and prospects of the issuer…" (Article 6(1) EU Prospectus Regulation and the UK Prospectus Regulation). In other cases, lead managers may advise that an issuer will get better terms from investors if it provides pro forma financial information, even though the inclusion of such pro forma financial information is not technically required by the standard set forth above. Finally, in the case of a Rule 144A/Regulation S offering, the pro forma information may be required on account of the US disclosure requirements, as discussed further below.

Accordingly, although in theory the definition of what amounts to a "significant gross change" is not applicable to DCM transactions because the EU/UK PR Delegated Regulations do not require pro formas to be included for debt securities, in practice, market participants do consider the test of whether a significant gross change has occurred as good guidance as to whether they should consider voluntarily including pro forma accounts in DCM offering documents.

What is a "significant gross change"?

Article 1(e) of the EU/UK PR Delegated Regulation defines significant gross change as a "variation of more than 25% to one or more indicators of the size of the issuer's business".

Given this is primarily relevant in the equity context, the FCA views the question of what is a relevant indication of size of a company entering into a transaction similarly to the relevant indicators used to assess class tests for the purposes of the significant transactions regime in Listing Rule 10. The basic class tests cover: (i) gross assets which are the subject of the transaction compared to the gross assets of the company; (ii) profits attributable to the assets the subject of the transaction compared to the profits of the company; (iii) consideration for the transaction compared to the market capitalisation of the company; and (iv) gross capital of the business being acquired compared to the gross capital of the company.[1]

Additional adjustments to the tests are relevant in the case of property companies (relating to the properties/assets), mineral companies (relating to the proven and probable reserves subject to the transaction) and scientific research based companies (which should consult with the FCA as to whether industry specific tests should be used in place of or in addition to the usual class tests).

Accordingly, for a company with a premium equity listing in the UK, a class 1 transaction under LR 10 will involve a significant gross change.

In a debt issuance context, the class tests are not directly relevant. The ESMA guidance on disclosure requirements under the Prospectus Regulation, published in March 2021 [2] (which applies in the UK in an amended format [3]), expands on the meaning of Article 1(e) by stating at Guideline 18 that the appropriate indicators of size will generally be the following line items: (i) total assets; (ii) revenue; and (iii) profit or loss. In respect of (ii) and (iii), to avoid any impacts of seasonality, the period used for testing should be a full financial year.

Where results are anomalous or inappropriate for the specific industry of the issuer, alternative indicators may be used. For example, a large company undertaking an otherwise small transaction to acquire a small business should not automatically be considered to have experienced a significant gross change just because in that year the profit of the large company was close to zero or negative, while the small company made a profit more than 25% of the acquiring company's profit. The context should be considered to determine whether it was actually a significant gross change for the large company (for example, was the relevant test on profit an anomalous result compared to a usual year?).

A significant gross change may occur where the relevant transaction has not yet taken place, but where the issuer has made a significant financial commitment (Article 18(4), EU/UK PR Delegated Regulation), being the entry into "a binding agreement to undertake a transaction that is likely to give rise to a [significant gross change]".

The FCA has published guidance that a pure fundraising transaction is not a significant gross change transaction (although the acquisition accompanying a fundraising may qualify).[4]

1 See FCA Listing Rule 10, Annex 1 "The Class Tests".
2 ESMA Guidelines: On disclosure requirements under the Prospectus Regulation, March 2021.
3 See FCA Primary Market Technical Note 619.1.
4 See FCA Primary Market Technical Note 633.2.

Aggregation of transactions in assessing significant gross change – a material difference in EU and UK approaches?

One key difference between the EU and the UK approach to assessing the 25% test arises when aggregating transactions. This distinction is clear when comparing the ESMA guidance of March 2021 and the FCA Technical Note 619.1 of May 2022. If an issuer has committed to several transactions below the 25% threshold in a financial period, which when aggregated would amount to a significant gross change (i.e. over 25%), or if an issuer has committed to one transaction over a 25% threshold followed by several smaller transactions, the question arises as to which of these transactions should be covered in the pro forma financial information. The ESMA guidance starts from the perspective that pro forma financial information covering all transactions should be included unless the inclusion would be unduly burdensome. The FCA starts from the opposite approach – pro forma financial information should not be included in relation to any of the transactions (apart from any that individually are over 25%), unless so doing would mean that the prospectus does not comply with the general disclosure obligation in Article 6(1) of the UK Prospectus Regulation.[5]

5 Where the UK Prospectus Regulation is applicable, the general disclosure obligation is that all information necessary for investors to make an informed assessment of the assets and liabilities, profits and losses, financial position, and prospects of the issuer must be included in the prospectus.

If pro forma information is to be included, what UK/EU regulatory requirements apply to how it is prepared and presented?

Whether there are any regulatory requirements as to the format which voluntarily included pro forma financial information must take depends on whether or not the offering document is subject to the EU or the UK Prospectus Regulation (which in the wholesale DCM context is primarily driven by whether the bonds are to be listed on a regulated market or not).

Regulatory requirements on the presentation of pro forma financial information if the bonds are being listed on a regulated market for the purposes of the EU Prospectus Regulation or the UK Prospectus Regulation

If pro forma financial information is included in a prospectus relating to debt and subject to the EU or UK Prospectus Regulation (e.g. by virtue of being listed on a regulated market), it is subject to the requirements of Annex 20 of the EU/UK PR Delegated Regulation.

Annex 20 of the EU/UK PR Delegated Regulation requires:

a) an introduction setting out the purpose for which the pro forma financial information has been prepared and a description of the transaction or significant commitment (and the entities involved);

b) a profit and loss account, a balance sheet or both (depending on the circumstances, see below: *Are both a pro forma balance sheet and a profit and loss statement always required?*) presented in columns[6];

c) explanatory notes; and

d) (where applicable) the financial information of the target company used to prepare the pro formas must be included in the prospectus.

In relation to item (d) above, typically, auditors of the issuer will only provide comfort on the underlying historical financial information of the target company where that audit firm also audited the underlying historical financial information of the target company. Where this is not the case, either the auditors of the target company would be requested to issue a comfort letter or if those auditors are not willing to do so, the lead managers may be willing to accept a certificate from the CFO of the issuer to support any financial information not comforted by the auditors.

In addition, Annex 20 requires that the prospectus includes a report prepared by the issuer's independent accountants or auditors stating that, in their opinion:

a) the pro forma financial information has been properly compiled on the basis stated in the prospectus; and

b) that it has been compiled on the basis consistent with the accounting policies of the issuer.

Requirements on the presentation of pro forma financial information if the bonds are being listed on a non-regulated market

There is considerably more flexibility regarding the presentation of pro forma financial information in debt offering documents for a non-regulated market listing, as non-regulated markets[7] generally do not apply any specific presentation requirements to pro formas. Accordingly, where pro forma financial statements are included in debt offering documents, the relevant exchange does not tend to comment on them nor check their content against any particular list of requirements. The issuer of course still needs to comply with any relevant rules of the exchange with regard to providing relevant information to the investor, and from a general liability perspective, ensuring that the presentation of any pro forma financial information is not misleading. The issuer's auditors may also have further requirements in order to provide the requested level of assurance to the lead managers.

6 The columns should comprise: (i) historical unadjusted information; (ii) accounting policy adjustments (if necessary); (iii) pro forma adjustments; and (iv) the pro forma financial results.

7 Non-regulated markets include multi-lateral trading facilities such as the London Stock Exchange's ISM, or Euronext Dublin's GEM, or another market outside the EU and UK such as The International Stock Exchange (TISE).

What period should the pro forma financial information cover?

The pro forma financial information should be consistent with the financial information included in the prospectus. Therefore, if the latest financial information disclosed in the prospectus is annual financial information, a pro forma profit and loss account should cover the latest full year and a pro forma balance sheet should state the position as at the end of the full year, if the transaction occurred after the end of the relevant period.

If the latest financial information in the prospectus relates to an interim period as well as disclosing the prior annual financial statements, the pro forma financial information could either relate to the most recent annual financial period, or relate to the more recent interim period, or relate to both the interim period and the most recent annual financial period.

ESMA and FCA guidance both provide that if pro formas are to be prepared on interim financial information, while normally half-yearly financial information should be used, if the issuer wishes to prepare pro forma information based on its most recent quarterly accounts, the issuer will have to ensure that the quarterly accounts have been prepared with the same care as half-yearly accounts (i.e. that IAS 34 has been applied). In addition, if the issuer's business is seasonal, the issuer will need to consider whether it is appropriate for the pro forma financial information to only cover the interim period, or whether this might lead to misleading results.

Is comparative pro forma financial information required and are pro formas required to be updated for interim financial periods in a later prospectus?

Comparative pro forma information for past periods should not be included. Pro forma financial information should only be published in respect of the last completed financial period (which ESMA guidance has clarified means the latest financial year that has closed) and/or, the most recent interim period for which relevant financial information has been published. It should be noted that this is an "and/or" requirement – even if there is interim period financial information included in the prospectus, if pro formas relating to the latest available completed annual financial period are included in that prospectus, there is no formal requirement to also provide pro formas in relation to the interim periods.[8]

For example, an MTN programme base prospectus that includes pro forma financial information relating to the most recent annual financial period, will not, when a supplementary prospectus is published to include later interim financial information, be required to include interim pro forma financial information (assuming that there has been no new trigger for the preparation of pro formas after the most recent annual financial year end).

Are both a pro forma balance sheet and a profit and loss statement always required?

It is important to remember that pro forma financial information is only relevant if the impact of the transaction or significant commitment has not already been reflected in the issuer's financial statements. As a balance sheet reports as of the balance sheet date (at the end of a financial period), and the profit and loss account reports in relation to whole financial period, it is therefore possible for a transaction that took place during the most recently completed financial period to be fully reflected in the balance sheet but not the profit and loss account. In this situation, only a pro forma profit and loss account would be required.

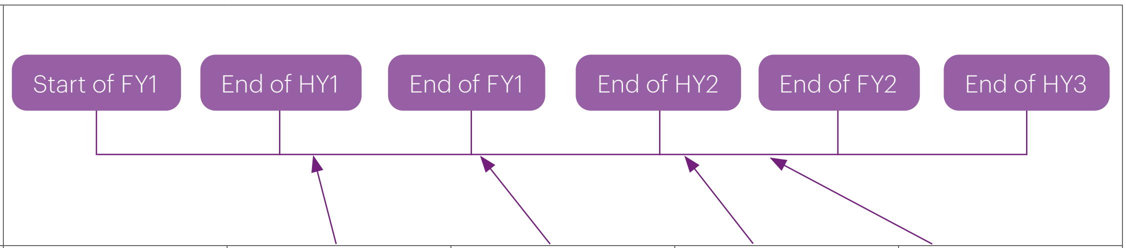
As can be seen from the examples below, depending on the timing of when the prospectus is published compared to the transaction triggering the inclusion of pro forma financial information, sometimes only a pro forma profit and loss account will be required, sometimes both a pro forma profit and loss account and a pro forma balance sheet will be required. In the following examples the transaction completes at the same point in time, it is simply the timing of the publication of the prospectus that changes between examples.

8 Notwithstanding the absence of a formal requirement, market participants often expect that pro forma financial information will cover both the annual period and subsequent interim period.

Example 1

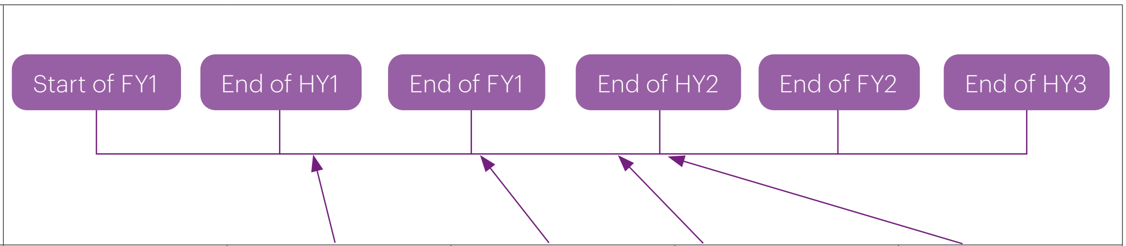
FY = Financial Year

HY = Half Year



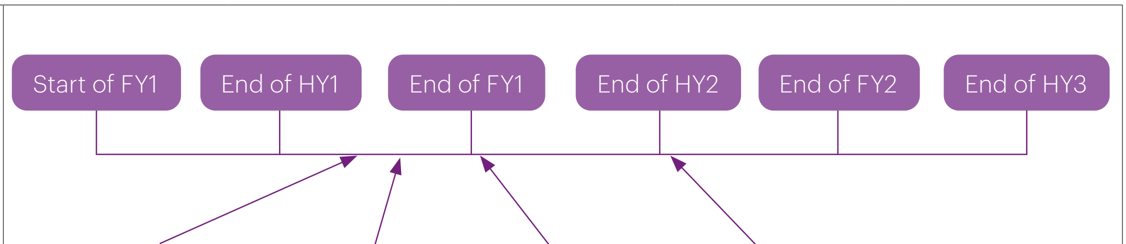
No pro forma financial information is required		Transaction completed	Financial year 1 balance sheet will fully reflect transaction	Half year 2 profit and loss account will fully reflect transaction, as will balance sheet	Prospectus published after release of HY2 accounts will not require any pro forma financial information

Example 2



Pro forma profit and loss account only required (no pro forma balance sheet)		Transaction completed	Financial year 1 balance sheet will fully reflect transaction	Prospectus published after FY1 accounts but prior to HY2 accounts will require pro forma profit and loss account (not balance sheet)	HY2 profit and loss account will fully reflect transaction, as will balance sheet

Example 3



Pro forma balance sheet and profit and loss account required	Transaction completed	Prospectus published prior to FY1 accounts will require pro forma financial information	Financial year 1 balance sheet will fully reflect transaction	Half year 2 profit and loss account will fully reflect transaction, as will balance sheet	

In all cases where a prospectus is published after a significant commitment is entered into but the transaction has not completed, both a pro forma profit and loss account and a pro forma balance sheet will be required if pro forma financial information is included. The financial statements of the issuer will not reflect the transaction to which the significant commitment relates until after completion of the transaction.

What additional considerations with regard to pro forma financial information arise from the offering to US Qualified Institutional Buyers (QIBs) under Rule 144A?

US securities law requirements for pro forma financial information are set out in Article 11 of Regulation S-X of the US Securities and Exchange Commission (the **SEC**), and Rule 3-05 of Regulation S sets out the requirements for the inclusion of financial information in respect of a company that has been acquired or disposed of. Formally, Rule 144A offerings are outside the scope of Regulation S-X, as they are exempt from registration with the SEC. However, the principles set out in Article 11 of Regulation S-X do provide the managers on Rule 144A offerings with a useful standard against which to consider whether the disclosure in the Rule 144A offering is adequate. Therefore, exceptions to the Regulation S-X requirements for pro forma and acquired company financial information set out below may be found in Rule 144A offerings, depending on the circumstances, and provided that the managers and issuer are comfortable that investors are being provided with the information they require to make an informed investment decision. These tests apply equally to acquisitions and dispositions, and only to transactions involving the acquisition or disposal of a business (not assets).[9]

High level summary of significance tests under Regulation S-X	
The investment test	The investment in (and advances to) the target compared to the issuer's market capitalisation (or if not available, issuer's total assets).
The asset test	Consolidated total assets of the target compared to the issuer's consolidated total assets.
The income test	Contains two separate elements: A. target (pre-tax and accounting principle changes) income from continuing operations[10] compared to equivalent income for the issuer for the most recent financial year; and B. target's consolidated total revenues compared to issuer's consolidated total revenues for the most recent financial year. The lower result of (A) and (B) determines the level of significance for the income test.
The overall level of significance is determined based on the highest of the investment, asset and income test.	

9 A transaction structured as an acquisition of assets (within the meaning of applicable SEC guidance) does not need to be tested against these requirements.
10 In the event of a loss, the absolute value of the relevant amount should be used.

High level summary of when target financials and pro formas are required under Regulation S-X	
Below 20% significance	No target financial statements or pro forma financial information required.
Above 20% but below 40% significance	Unless the target has been accounted for in the issuer's results for nine months, target financial statements and pro forma financial information are required. Target financial statements for the most recent financial year only are required (and any more recent interims).
Above 40% but below 50% significance	Unless the target has been accounted for in the issuer's results for one year, target financial statements and pro forma financial information are required. Target financial statements for the two most recent financial years are required (and any more recent interim financial information).
Above 50% significance	Unless the target has been accounted for in the issuer's results for one year, target financial statements and pro forma financial information are required. Target financial statements for the two most recent financial years are required (and any more recent interims plus the corresponding year interims). Note if the 50% significance level is exceeded only because of the aggregation of multiple transactions acquiring unrelated businesses that are each below 20% significance, target financial information and pro formas are not required. If the 50% significant level is exceeded because of the aggregation of multiple transactions acquiring unrelated business but only one such transaction is above 20%, target financial information and pro formas are required in respect of that target only.

Where included, pro forma financial information is provided for only the most recent annual period and any subsequent interim period for which financial information is included; pro forma information for prior reporting periods is not provided.

For transactions at a significance level of less than 50%, the SEC provides that financial statements and pro forma information do not need to be provided for an acquisition that was consummated less than 75 days prior to the date of the relevant filing. Any offering document must also include any information that is or may be material to an investor for making an investment decision in the company, regardless of the specific outcome above.

An acquisition that is probable should be assessed in accordance with the same tests.

If pro forma financial information is required, Regulation S-X requires that this be presented in the form of a condensed pro forma balance sheet as at the end of the most recent financial period, and a profit and loss account for the most recent year and (if relevant) interim period (unless already included in the issuer’s financial statements for that period).

Further questions

If you do wish to discuss pro forma financial information, or any other issues in the debt capital markets further, please feel free to contact any of the Dentons Debt Capital Markets team.

Key contacts

David Cohen
Partner, London
D +44 20 7246 7535
david.cohen@dentons.com

Nick Hayday
Partner, London
D +44 20 7246 7516
nick.hayday@dentons.com

Neil Dixon
Partner, London
D +44 20 7246 7522
neil.dixon@dentons.com

Cameron Half
Partner, Capital Markets and US Securities Laws, London
D +44 20 7246 7175
cameron.half@dentons.com

Alex Roussos
Partner, Dubai
D +971 4 402 0895
alex.roussos@dentons.com

Victoria Wyer
Partner, London
D +44 20 7320 6340
victoria.wyer@dentons.com

Brian O'Leary
Senior Associate, Dublin
D +44 20 7246 7499
brian.oleary@dentons.com

James Osun-Sanmi
Senior Associate, Dubai
D +971 4 402 0929
james.osun-sanmi@dentons.com

David Ferris
Managing Practice Development Lawyer, London
D +44 20 7320 6353
david.ferris@dentons.com

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