WHITE & CASE

Capital Markets Blueprints

Preparing for Pro Formas

2021

Contents

Foreword 1

When should issuers prepare pro forma financials? 2

Financial information requirements table for potential offering memorandum 5

Anticipating the preparation of target and pro forma financials 6

Why should issuers prepare pro forma financials? 7

Frequently asked questions 8

Key takeaways 9

Contacts 10

Foreword

Pro forma financial statements may be required in a securities offering where an acquisition or disposition has occurred or is probable within a certain period of the offering. In a Rule 144A offering, market practice is generally to follow requirements applicable to SEC registered deals. Among other deal scenarios, buyers who need or intend to finance an acquisition with equity or debt in the capital markets, and investment banks involved in any such financing, should consider the potential need for information about the target and standalone target financial statements, including the need for pro forma financials.

This blueprint provides both:

- the necessary tools for issuers and investment banks to anticipate the need for the disclosure of target business financial statements and related pro formas, in particular, in connection with an acquisition; and
- the legal framework behind the requirements for such financial statements and pro formas, providing important context to why transaction participants should be prepared to apply the right resources to the workstream.

This **White & Case Capital Markets Blueprint: Preparing for Pro Formas** sets out practical advice for issuers and investment banks on financial statements for capital markets offerings, with a focus on acquisition scenarios.

When should issuers prepare pro forma financials?

The factors explained in this section govern whether, and for what periods, an issuer is required to present historical financial statements of the target and related pro forma financial statements.

Is the target a "business"?

Target business financial information is required in the offering memorandum only if the target is a "business." The term "business" used by the SEC should be understood as a separate operating unit, a subsidiary or an independent business entity which, following the acquisition or disposition, shows or is expected to show a continuity in its operations compared to the time before the closing of the acquisitions or disposition. It may also, in some circumstances, be comprised of a separate product line. The legal form of the acquisition, e.g., stock purchase or asset purchase, does not affect the determination of whether a "business" has been acquired under SEC rules.

Is the transaction closed, or probable?

Whether the target business financial information is required in the offering memorandum also depends on when the acquisition "closed" or, if it has not yet occurred, whether it is "probable":

- **Closed acquisition** – Issuers must include the financial information for a significant acquisition of a business or multiple businesses that has closed 75 days or more before the issue date. This significance threshold is set at 20%, below which the issuer has no obligation to provide the financial statements of the recently acquired business as further explained below. The 75-day window does not apply if the significance is above the 50% threshold.
- **Probable acquisition** – The term "probable" is not defined in Rule 3-05, however in practice, a probable acquisition is a situation where the issuer and the target business or businesses have entered into a binding sale and purchase agreement or have signed a letter of intent, or where the transaction has been approved by the board or shareholders of the seller, or a public announcement of the acquisition has been made.

If the target is a business as defined in this section and fits within one of the two above categories, it should then be determined whether such acquisition is significant.

Is the transaction significant?

The significance test set out in Rule 1-02(w) is broken out into three different tests: (i) the investment test, (ii) the income test and (iii) the asset test. Target historical financial information is required if the acquisition or the contemplated acquisition of a significant portion of a business or multiple businesses exceeds the 20% threshold on any of those three tests. All three tests must be performed, the significance level is determined by the highest percentage calculated by the three tests.

- **Investment Test** – The amount of the issuer's investment in the acquired business (generally, the aggregate value of the acquisition) would exceed 20% of the issuer's aggregate worldwide voting and non-voting common equity market value. Where an issuer does not have an aggregate worldwide market value, the consolidated total assets as of the end of the issuer's most recently completed fiscal year should be used as the base for this test.
- **Income Test** – The income test requires two components to be measured: the revenue component and the net income component. The net income to apply is the income from continuing operations before taxes, extraordinary items and cumulative effects of changes in accounting principles. As per the investment test, if the share of the target's total revenue and income from continuing operations exceeds 20% of the issuer's total revenue and income from continuing operations for the most recent fiscal year, then the preparation and disclosure of target historical financial information is required. Both components should be tested and if any of the two components does not exceed 20% significance, then the target acquisition is not considered significant under the income test. Finally, in order to determine the number of periods for which Rule 3-05 financial statements are required, the issuer may use the lower of the revenue component and the net income component.

- **Asset Test** – The issuer's share of the total assets of the target would exceed 20% of the issuer's consolidated total assets as of the end of its most recently completed fiscal year.

For a probable acquisition, the significance test is 50% of the relevant metrics, however marketing or materiality factors in relation to the overall transaction may dictate for the inclusion of relevant financial statements and pro formas, particularly where the use of proceeds of the securities offering are to be used to finance the acquisition.

Under Rule 3.05, target financial statements may be required for up to two years (together with the comparative period) depending on the level of significance of the acquired or to-be-acquired business. Where the acquisition is for a product or business line, certain specific rules have been enacted such that abbreviated financial statements omitting certain information may be permissible. When target financial statements are required under Rule 3.05, then pro forma financial information must also be included in compliance with Article 11 of Regulation S-X. The table below presents the different scenarios on the treatment of the target financial information to be provided in the offering memorandum in the context of a 144A offering and the related pro forma historical financial information required:

<table>
<tr><th>Significance level</th><th>Target historical financial statements required</th><th>Pro forma historical financial statements required</th></tr>
<tr><td>Less than 20% significance</td><td>No target financial statements required</td><td>No pro forma financial statements required</td></tr>
<tr><td>Greater than 20% significance but less than 40%</td><td>The most recent year of audited financial statements, and the unaudited financial statements for the most recent interim period, if applicable, with no comparative period required

The issuer can leave out the separate target financial statements once they have been included in its post-acquisition financial statements for at least nine months</td><td rowspan="2">Article 11 of Regulation S-X requires that the issuer provide unaudited pro forma financial information relating to a significant acquisition. Pro forma financial information typically includes a pro forma balance sheet and pro forma income statements based on the historical financial statements of the issuer and the acquired business, including adjustments intended to show how the acquisition might have affected or might affect the issuer's financial statements</td></tr>
<tr><td>Greater than 40% significance</td><td>The two most recent years of audited financial statements, and the unaudited financial statements for the most recent interim period, if applicable, together with the comparative period from the prior year in compliance with IAS 34.20

The issuer can leave out the separate target financial statements once they have been included in its post-acquisition financial statements for at least a full fiscal year</td></tr>
<tr><td>Multiple individually insignificant acquisitions lower than 20% significance individually or within the 75 days grace period, but aggregating for more than 50% significance on a combined basis</td><td>The most recent year of audited financial statements, and the unaudited financial statements for the most recent interim period, if applicable, with comparative period will be required for businesses whose individual significance exceeds 20%, but are within the 75 days grace period</td><td>Pro forma financial information required for individually insignificant businesses (below 20%) but aggregating more than 50% significance on a combined basis</td></tr>
</table>

When should issuers prepare pro forma financials? (continued)

Pro forma presentation requirements

The key role of pro forma financial information is to allow investors to make an informed investment decision, by understanding the impact of a transaction by illustrating how that transaction may have affected the issuer's historical financial statements. Article 11 of Regulation S-X requires:

- **A pro forma condensed balance sheet:** As of the end of the most recent period for which a consolidated balance sheet of the issuer is required, unless the transaction is already reflected in that balance sheet. The pro forma condensed balance sheet is prepared as if the transaction had occurred on the date of the issuer's latest historical balance sheet included in the offering memorandum; and
- **A pro forma condensed income statement:** For the issuer's most recently completed fiscal year and the most recent interim period of the issuer, unless the historical income statement reflects the transaction for the entire period. The pro forma condensed income statement is prepared as if the transaction had taken place at the beginning of the issuer's latest fiscal year for which an income statement is included in the offering memorandum.

Multiple individually insignificant acquisitions

Pro forma financial information should be prepared in cases where the aggregate effects of all acquisitions exceed 50% significance, but historical financial statements will be required only for those businesses whose individual significance exceeds 20%.

Dispositions of businesses

An issuer must prepare and provide pro forma financial information for any disposition of a business that exceeds the 20% significance threshold using the same test presented above.

Financial information requirements table for potential offering memorandum

After determining whether, and for what periods, an issuer is required to present historical financial statements of the target and related pro forma financial statements, the following chart summarizes the comfort package to be received in a context where historical financial statements of the target and related pro forma financial statements are required based on the foregoing analysis.

	Required financial information	Required auditor comfort/negative assurance for securities offering
Purchaser	Audited financial statements for the last three fiscal years, including footnotes	Auditor to provide Statement of Auditing Standards No. 72 ("SAS 72") review and comfort
	Reviewed financial statements for interim period if more than 134 days past last reviewed or audited financial statements, plus comparison period, including footnotes	Standard negative assurance post-last balance sheet date to be provided
	Current trading information (depending on timing of offering)	Typically provide qualitative or quantitative statement about figures since last period reported
Target	Audited financial statements for the last one to two years, depending on the significance threshold of the acquisition as further explained hereinafter, including footnotes	Auditor to provide SAS 72 review and comfort
	Reviewed financial statements for interim period if more than 134 days past last reviewed or audited financial statements, plus comparison period, including footnotes	Standard negative assurance post-last balance sheet date to be provided
	Current trading information (depending on timing of offering)	Typically provide qualitative or quantitative statement about figures since last period reported
Pro Forma Financial Information	Pro forma financial information to be built up from purchaser financial statements plus target results and adjustments. Management adjustments depicting synergies of the acquisitions for which pro forma effect is being given may be included if, in management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction and certain conditions related to the basis and the form of presentation are met	Auditor to provide SAS 72 negative assurance and comfort on pro forma financial information

Anticipating the preparation of target and pro forma financials

Preparing financial information requires cooperation between the target and the issuer.

Depending on the structure of the acquisition (whether share sale, asset sale, demerger or spin-off) the financials of the target may not be readily available to the acquiror. This is particularly the case in the increasingly common circumstance where an offering of securities occurs before closing of the acquisition and the proceeds of such offering will be held in escrow pending such closing. Consideration of both the need for such information and financials and the type of financials required should be made prior to the signing of the acquisition agreement. It is important when negotiating the acquisition agreement with the seller to ensure the seller's cooperation (and that of their auditors) in preparing for the financing transaction between signing the acquisition agreement and closing the acquisition. A cooperation clause in an acquisition agreement would ideally include the following aspects, which would allow the purchaser to work with the target on preparing the required target and pro forma financials:

- **Personnel (who should cooperate)** – cooperation of seller, which shall procure cooperation from the target and target group, plus respective directors, officers, employees, accountants and other professional advisors and representatives;

- **Activities (what should the cooperation consist of)** – cooperation and assistance (in each case to the extent such cooperation and assistance is legally permissible and does not interfere unreasonably with the target's operation) with prospective debt financing providers, rating agencies and other professional advisors and representatives in connection with and in order to facilitate the debt financing including: lender, investor and rating agency meetings, road shows, due diligence sessions and drafting sessions, assisting with the preparation of credit rating agency presentations, bank information memoranda, offering or private placement memoranda, prospectuses and other similar offering documents; and providing due diligence materials, 'know your customer' (KYC) documents and any other customary documents. As part of this process, the target will also need to provide other business information to provide the materials for the preparation of the relevant securities offering document which will describe the target business in detail;

- **Financials (what financials will be provided)** – providing customary audited annual and reviewed interim financial statements of the target and equivalent financial statements for the preceding financial years, audit reports and other financial information (including pro forma financial information), in each case as of the most recent balance sheet date that falls no earlier than 134 days prior to the expected date of pricing of any debt financing to be issued in cooperation with prospective debt financing providers. The financial statements must satisfy the required age-of-financial statements requirements, known as the "staleness" rules. "Staleness" is the point in the quarter (in the case of year-end, first and second quarter financial statements) or the point in the subsequent fiscal year (in the case of third quarter financial statements) when the prior year-end or quarter's financial statements become so dated that the financial information provided in the disclosure needs to be updated with the subsequent quarter's or the full fiscal year's financial statements, as applicable in order for auditors to provide customary negative assurance comfort to the initial purchasers; and

- **Auditors (which auditors are involved)** – facilitating cooperation between the target, the target's auditors and the purchaser's auditors, to ensure that the target and its auditors will be providing all the necessary information and perform the necessary procedures to prepare the required target financial information, which will allow the issuer to prepare the relevant pro forma financial statements. In addition, the target's auditors will provide a comfort letter in connection with the underlying securities offering.

Why should issuers prepare pro forma financials?

Having set out the practical requirements for pro forma financials, the following sets out the rules upon which such requirements are based.

Purpose of pro forma financials

Pro forma financials required in a Rule 144A transaction are the consequence of the market practice to follow requirements applicable to SEC registered deals, but also as an indirect consequence of the disclosure obligations set by Rule 10b-5. The key role of pro forma financial information is to allow investors access to the necessary information in order for them to assess the company's financial situation as if a specific transaction, such as an acquisition or multiple acquisitions or a business disposition, had occurred at the beginning of the applicable financial period presented, which would allow potential investors to better assess the overall business following the already closed or probable acquisition of a business.

SEC requirements and Rule 144A offerings

The requirements set by Rule 3-05 and Article 11 on target business historical financial statements and related pro forma financial information disclosure requirements have become relevant in Rule 144A offerings as a result of market practice. While generally SEC requirements do not technically apply to Rule 144A offerings, standard market practice substantially follows these requirements in the context of 144A offerings. Initial purchasers and investors have come to expect that the financial disclosures in a Rule 144A offering memorandum, and with it, the inclusion of target business and related pro forma financial statements in connection with a significant acquisition that has occurred or that is probable to occur would be consistent with the required financial disclosures in an SEC registered transaction. It is worth noting that since those requirements for non-registered deals are market practice, issuers and their counsel should coordinate with the initial purchasers to discuss the marketing need for the disclosure of target business and related pro forma financial statements in the context of an acquisition financing or high yield offering following a recently closed acquisition by the issuer.

Disclosure requirements and Rule 10b-5

It is also relevant to look at the disclosure of a target business' financial information and related pro forma financial information through the prism of Rule 10b-5. Rule 10b-5 provides that in connection with the sale of securities, the issuer of such securities must not make any untrue statement of a material fact or omit a material fact necessary to make the statements made, in the light of the circumstances under which they are made, not misleading. As a result, where a binding agreement with respect to a material acquisition has been signed or is probable at the time of an offering, failing to disclose such an agreement along with the relevant information related to the target business, including the target financial information, could give rise to claims against the issuer under Rule 10b-5.

Frequently asked questions

The following are questions that are frequently raised with respect to pro forma financial statements and related matters in a securities offering:

Q: Should the significance level of the target be calculated using the purchaser's financials or the target's and purchaser's combined financials?

A: The significance level of the target should not be calculated by using combined figures, each test must be performed using the financials of the purchaser only.

To give an example using the asset test:

- Purchaser has €500 million of assets
- Target has €110 million of assets

Using the 20% threshold test as discussed above, the test is whether the Target comprises 20% of €500 million (and not 20% of the combined €610 million).

Q: Should the significance level of the target be calculated using the purchaser's last 12 months financials or the last audited fiscal year?

A: As a general rule, the significance level of the target should be calculated by using the financials of the last audited fiscal year of the purchaser. This is notwithstanding the fact that the transaction may be being marketed off a "last 12 months" metric.

Q: What level of comfort will auditors provide on pro forma financials?

A: For SEC registered deals, auditors usually only provide negative assurance that the pro forma financial information complies as to form in all material respects with the applicable accounting requirements provided under Rule 11-02 of Regulation S-X. Auditors on registered deals may also be asked to check the arithmetic accuracy of the pro forma adjustments to confirm whether the pro forma adjustments have been properly applied to the historical amounts in the compilation of the pro forma financial statements. In a 144A offering, auditors will also provide negative assurance by confirming that nothing caused the auditors to believe that the unaudited pro forma combined financial information included in the offering memorandum does not comply in all material respects with the pro forma basis described in the unaudited pro forma combined financial information, and that the pro forma combined adjustments have not been properly applied to the historical amounts in the compilation of the unaudited pro forma combined financial information. Some auditors, depending on the jurisdiction of the purchaser, will provide a circling on the pro forma financials confirming the arithmetic accuracy of the pro forma information provided in the offering memorandum.

Key takeaways

A significant business acquisition represents an important event in the life of a business. Because a significant acquisition often results in significant changes to an issuer's financial position, results of operations, and future prospects, disclosure rules and market practice require specific items to be prepared and disclosed to investors. Consideration of both the need for such information and financials and the type of financials required should be made prior to the signing of the acquisition agreement in order to ensure the cooperation of the seller and the target through the inclusion of a proper provision. Understanding the issues at stake, discerning these rules and anticipating their application is paramount for issuers to meet market standards and to carry out any contemplated securities offerings in a timely fashion.

Issuers should carefully review the rules, evaluate the applicable facts and circumstances, and work with initial purchasers, counsel and auditors in carrying out their significance analysis and financial reporting presentations.

Contacts

EMEA leveraged finance partners

Nicola Chapman ■
Partner, London
T +44 20 7532 1297
E nicola.chapman@whitecase.com

Jill Christie ●
Partner, London
T +44 20 7532 1534
E jill.christie@whitecase.com

Christopher Czarnocki ■
Partner, London
T +44 20 7532 1201
E cczarnocki@whitecase.com

Jeremy Duffy ■
Partner, London
T +44 20 7532 1237
E jduffy@whitecase.com

Gareth Eagles ■ ●
Partner, London
T +44 20 7532 1251
E geagles@whitecase.com

Jacqueline Evans ■
Partner, London
T +44 20 7532 1404
E jevans@whitecase.com

Martin Forbes ■
Partner, London
T +44 20 7532 1229
E martin.forbes@whitecase.com

Emma Foster ■
Partner, London
T +44 20 7532 1299
E efoster@whitecase.com

James Greene ■ ●
Partner, London
T +44 20 7532 1439
E jgreene@whitecase.com

James Hardy ■
Partner, London
T +44 20 7532 2728
E james.hardy@whitecase.com

Colin Harley ■
Partner, London
T +44 20 7532 1200
E colin.harley@whitecase.com

Monica Holden ●
Partner, London
T +44 20 7532 1483
E mholden@whitecase.com

Richard Lloyd ■
Partner, London
T +44 20 7532 1247
E richard.lloyd@whitecase.com

Shane McDonald ■
Partner, London
T +44 20 7532 2698
E shane.mcdonald@whitecase.com

Shameer Shah ■
Partner, London
T +44 20 7532 1215
E shameer.shah@whitecase.com

Gilles Teerlinck ■ ●
Partner, London
T +44 20 7532 2232
E gilles.teerlinck@whitecase.com

Fergus Wheeler ■
Partner, London
T +44 20 7532 2288
E fergus.wheeler@whitecase.com

Thierry Bosly
Partner, Brussels
T +32 2 2392 509
E tbosly@whitecase.com

Hadrien Servais
Partner, Brussels
T +32 2 2392 544
E hadrien.servais@whitecase.com

Claire Matheson Kirton ■
Partner, Dubai
T +971 4 381 6218
E cmathesonkirton@whitecase.com

Rebecca Emory ●
Partner, Frankfurt
T +49 69 29994 1432
E rebecca.emory@whitecase.com

Dr. Thomas Flatten
Partner, Frankfurt
T +49 69 29994 1233
E tflatten@whitecase.com

Andreas Lischka
Partner, Frankfurt
T +49 69 29994 1128
E andreas.lischka@whitecase.com

Sebastian Schrag
Partner, Frankfurt
T +49 69 29994 1139
E sebastian.schrag@whitecase.com

Vanessa Schuermann ■
Partner, Frankfurt
T +49 69 29994 1431
E vanessa.schuermann@whitecase.com

Gernot Wagner ●
Partner, Frankfurt
T +49 69 29994 1430
E gernot.wagner@whitecase.com

Florian Ziegler
Partner, Frankfurt
T +49 69 29994 1575
E florian.ziegler@whitecase.com

Yannick Adler ●
Partner, Frankfurt
T +49 69 29994 1437
E yannick.adler@whitecase.com

Güniz Gökçe
Association Partner, Istanbul
T +90 212 355 1311
E guniz.gokce@gkcpartners.com

LON1021091-10

Fernando Navarro ■
Partner, Madrid
T +34 91 787 6373
E fernando.navarro@whitecase.com

Yoko Takagi
Partner, Madrid
T +34 91 7876 320
E yoko.takagi@whitecase.com

Iacopo Canino
Partner, Milan
T +39 02 00688 340
E icanino@whitecase.com

Giuseppe Barra Caracciolo
Partner, Milan
T +39 02 00688 400
E giuseppe.barracaracciolo@whitecase.com

Gianluca Fanti
Partner, Milan
T +39 02 00688 390
E gianluca.fanti@whitecase.com

Michael Immordino ●
Partner, London
T +44 20 7532 1399
E mimmordino@whitecase.com

Evgeny Scirto Ostrovskiy ●
Partner, Milan/London
T +44 20 7532 1278
E evgeny.scirto@whitecase.com

Andrea Novarese
Partner, Milan
T +39 02 00688 440
E andrea.novarese@whitecase.com

Natalia Nikitina
Partner, Moscow
T +7 495 787 3027
E nnikitina@whitecase.com

Samir Berlat
Partner, Paris
T +33 1 5504 1551
E samir.berlat @whitecase.com

Denise Diallo ●
Partner, Paris
T +33 1 5504 1518
E ddiallo@whitecase.com

Roman Picherack ●
Partner, Paris
T +33 1 5504 5872
E roman.picherack@whitecase.com

Raphaël Richard
Partner, Paris
T +33 1 5504 1538
E rrichard@whitecase.com

Tomáš Jíně ■
Partner, Prague
T +420 255 771 233
E tomas.jine@whitecase.com

Jan Linda
Partner, Prague
T +420 255 771 271
E jlinda@whitecase.com

David Plch
Partner, Prague
T +420 255 771 298
E dplch@whitecase.com

Jonathan Weinberg ■
Partner, Prague
T +420 255 771 262
E jweinberg@whitecase.com

Oscar Liljeson
Partner, Stockholm
T +46 8 50632 379
E oscar.liljeson@whitecase.com

Carl Hugo Parment
Partner, Stockholm
T +46 8 50632 341
E carlhugo.parment@whitecase.com

Magnus Wennerhorn
Partner, Stockholm
T +46 8 50632 370
E magnus.wennerhorn@whitecase.com

Tanja Törnkvist
Partner, Helsinki
T +358 9 228 64 351
E ttornkvist@whitecase.com

Grzegorz Abram
Partner, Warsaw
T +48 22 5050 125
E grzegorz.abram@whitecase.com

Marcin Studniarek
Partner, Warsaw
T +48 22 50 50 132
E mstudniarek@whitecase.com

Bartosz Smardzewski
Counsel, Warsaw
T +48 22 50 50 100
E bsmardzewski@whitecase.com

■ English Qualified
● US Qualified

WHITE & CASE

whitecase.com

© 2021 White & Case LLP