

Illustrative complex financial history disclosures*

A PricewaterhouseCoopers Capital Markets Group
European Prospectus Disclosure guide



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Preface

This booklet has been prepared in order to assist companies and their advisers in their consideration of the historical financial information that needs to be included in a prospectus under the EU Prospectus Directive regime.

This represents a high level summary of the many complex issues arising. Readers should refer to the companion European Prospectus Disclosure Guide on complex financial histories for a more detailed analysis.

We particularly welcome the fact that the European Commission has taken a principles based approach to solving the financial information question. This booklet provides illustrations as to how they might be applied to a number of common scenarios drawing on our extensive experience of working with clients producing prospectuses.

Companies' financial histories are often complex and early consideration of the likely prospectus requirements, in consultation with auditors and other advisers, is vitally important if a smooth passage to a successful offering, or admission to trading, of its shares is to be achieved.

We would like to thank Kevin Desmond and our network of capital market experts across Europe for their assistance in producing this booklet and its companion Guide.

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Overview

Introduction

The need to amend the Prospectus Regulation arose from questions as what was required to be disclosed when an issuer's accounts did not fully represent its current businesses over the past three years. The European Commission has responded by issuing an Amending Regulation that this booklet summarises and illustrates the consequences of.

Historical financial information requirements

The basic requirement set out in the Prospectus Regulation is for three year's audited financial information on an issuer.

What is meant by a complex financial history?

A complex financial history arises whenever the statutory accounts of an issuer do not portray the record of all of its current businesses throughout the last three years. Additional financial information disclosure is required for material acquired businesses prior to their acquisition.

A significant financial commitment

An issuer may have entered into a commitment to acquire another business material to it. In which event additional historical financial information is required.

The test of significance

Materiality is addressed by reference to equivalent provisions to those dictating the need for pro forma financial information being whether the size of an acquired business is more than 25% that of the issuer.

Deciding what to disclose

The Amending Regulation provides that issuers can take into account the costs of providing historical financial information on an acquired business in a prospectus when debating whether providing such information benefits investors.

Interaction with other requirements

Issuers should have regard to equivalent provisions in other markets where shares may be being offered such as the United States of America or related eligibility for listing provisions that exist, for example, in the UK and Ireland.

A role for pro forma financial information

Pro forma financial information is defined narrowly by the Prospectus Regulation to show the impact of a transaction on an issuer's latest financial information. In the situation of a complex financial history it is seen as complementary to the disclosure of additional historical financial information.

When is a year not a year?

The Amending Regulation also clarifies that at least 36 months financial information must be presented even though an issuer may have shortened a financial year on changing its accounting reference date.

What issuers need to do

The most important thing is for issuers to be conscious of the need to consider whether they have, or are likely to have, a complex financial history as early as possible in the timeline towards an admission to trading or public offer of their shares. The sooner that the issue is identified the sooner that solutions and alternatives can be determined and costed.

It would also be appropriate to engage the investment bank(s) likely to be involved in the selling of the shares to ascertain their view as to the impact of any solution on the offering. Only then will it be possible to secure the agreement of the competent authority to the preferred solution and the earlier such agreement is reached the smoother will be the prospectus preparation and approval process.

Some illustrations

The specific nature of the individual circumstances of an individual case means that it is not possible to prescribe a solution that would be expected to be followed. Nor is it possible to explore every possible permutation of circumstances in defining solutions that should be applied.

Sensibly, the authors of the amendment to the Prospectus Regulation acknowledged that this was the case and, instead of seeking to provide prescriptive solutions, have set out the principles we have explored in this Guide.

However, in order to assist in the application of these principles we have sought to identify a number of the more common situations that we have come across when advising on the financial information to be included in a prospectus. We have used these as examples to illustrate the possible solutions that could be applied in each case and expressed our view as to the most appropriate.

- 1 Significant acquisition made in the financial history period
- 2 Acquisition to be made by newly incorporated holding company
- 3 Significant disposal made in the financial history period
- 4 A de-merger or division from an existing group
- 5 A private equity backed acquisition in the three year history

Clearly this list is not exhaustive but it should provide some indication of the analysis that would need to be undertaken when faced with a particular fact pattern.

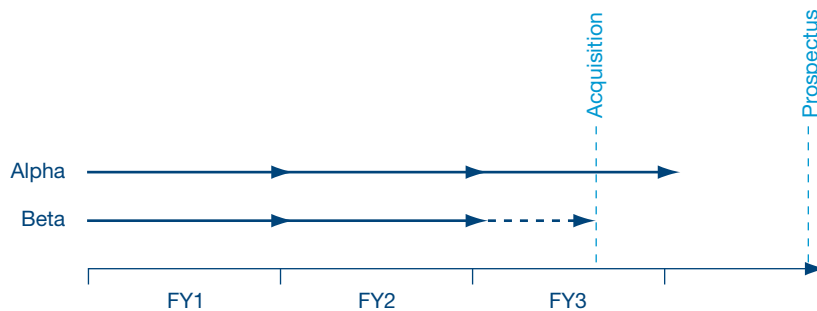
In due course issuers will be able to have regard to prospectuses issued by other companies that may provide some indication as to the approach they might wish to adopt. However, such precedents may need to be treated with caution as it will be appreciated that all of the facts and circumstances leading to a particular form of disclosure in another prospectus may not be readily apparent.

1 Significant acquisition made in the financial history period

Fact pattern

Alpha has been in existence for many years and has prepared consolidated accounts in accordance with IFRS. Alpha acquired Beta during its latest financial year. Beta was approximately half the size of Alpha when measured relevant to indicators of size such as turnover and profitability. We will assume that Beta also used IFRS when preparing its consolidated financial statements.

Alpha is seeking admission to trading on an EU regulated exchange for the first time.



Analysis

Alpha has a complex financial history having made an acquisition of a business undertaking in its three year track record period and, as the acquired business undertaking is significant, some additional financial information disclosure might well be expected. As Alpha's prospectus is being prepared in connection with an initial admission to trading the benefit threshold would be set quite high.

What financial information should be presented in the prospectus?

As a starter, it will be necessary to include Alpha's financial information for its last three financial years.

As regards Beta, the following options are available:

- Rely on the disclosures made by Alpha in its latest financial statements about the acquisition of Beta. (Option 1A)
- Include separate financial information on Beta for its latest financial years, FY1 and FY2, prior to its acquisition by Alpha. (Option 1B)
- Include separate financial information on Beta not only for its latest financial years prior to its acquisition by Alpha but also through to the date of its acquisition that is FY1, FY2 and part of FY3. (Option 1C)
- Include separate financial information on Beta for its last three financial years ending immediately after the date of its acquisition by Alpha, ie all of FY1, FY2 and FY3. (Option 1D)

It might also be appropriate to include a pro forma income statement for FY3 illustrating the effect of bringing together Alpha and Beta as if they had been together at the beginning of that year.

PwC view

Option 1C would provide the most complete set of financial information tying in Beta's record through to its date of acquisition and consolidation by Alpha and providing the components necessary to construct a pro forma income statement. However, drawing up and auditing a financial record of Beta through to its date of acquisition by Alpha could be difficult to deliver. In such circumstances, we would support Option 1D over Option 1B, as this would avoid a gap in the financial record being presented.

Option 1A would be most appropriate where the issuer is already publicly traded in that the information in Alpha's accounts would be the basis on which the market is trading in Alpha's shares.

Extra thoughts

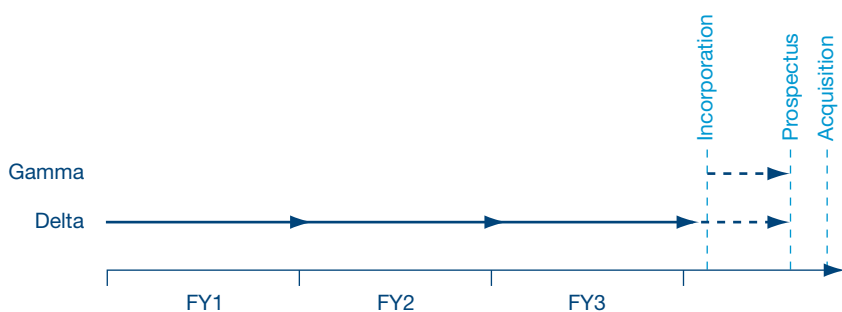
The above example is quite simple and can easily be complicated in a number of different directions:

- Would the answer differ if the acquisition of Beta had occurred in the middle or first year of the three year financial history period?
- If Beta has not been an IFRS reporter?
- If Alpha elects to only present FY2 and FY3 on an IFRS basis, presenting FY1 and, following CESR's Recommendations, FY2 on its previous EU national GAAP basis?
- If there was more than one acquisition in the track record period?

2 Acquisition to be made by newly incorporated holding company

Fact pattern

Gamma is a recently incorporated company formed for the purposes of making an offer and admission to trading of its shares to finance the acquisition of Delta. Delta has existed for a number of years as the parent of a business undertaking that it had acquired with private equity finance.



Analysis

This represents a straightforward example of a significant financial commitment, in that Delta is quite obviously significant in relation to an entity that has only recently been formed.

What financial information should be presented in the prospectus?

Applying the principles of the new rules and deeming Delta to be the issuer would lead to the inclusion of historical financial information on Delta for each of its last three financial years.

In addition, it may also be necessary to present separate financial information on Gamma itself. As statutory financial statements would not have been prepared for Gamma, it would be necessary to draw up, and have audited, special purpose financial statements to a convenient period end date if it has not reached its first financial year end.

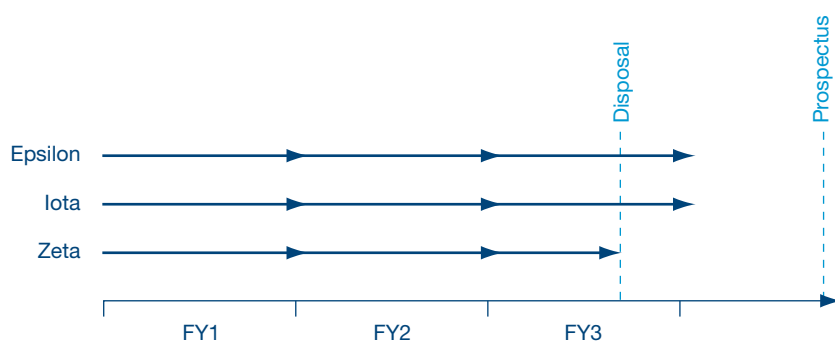
PwC view

The solution that requires Delta's three year history to be presented is that which should be followed in such cases.

3 Significant disposal made in the financial history period

Fact pattern

An entity Epsilon has been the holding company for two substantive business undertakings over the past three financial years: Zeta and Iota. Apart from some shared overheads, Zeta had no trading relationship with Iota. In its latest financial year Epsilon disposed of Zeta. Zeta accounted for approximately one-third of Epsilon's assets and profits. Again, assume that Epsilon has prepared consolidated IFRS financial statements for each of its past three financial years. Epsilon is preparing a prospectus in connection with an initial offer and admission to trading of its shares.



Analysis

Clearly Epsilon's consolidated accounts do reflect the entire business undertaking that it has owned in the track record period. However, they do not reflect the entire business undertaking at the date the prospectus has been drawn up as by then Zeta has been disposed of. Accordingly, the question of a complex financial history needs to be considered.

What financial information should be presented in the prospectus?

The following options are available:

- Rely on the statutory financial statements of Epsilon, which, in FY 3, would have shown Zeta as a discontinued operation on one line in the income statement for FY3 and the comparatives for FY2. In FY2 and FY1's statutory financial statements it should be possible to see the results of Zeta and Iota in the segment reporting note. (Option 3A)
- As well as the Epsilon financial statements and the pro forma FY3 income statement present Zeta's financial statements. This would enable investors to see the full performance of the business undertaking disposed of. (Option 3B)
- As well as the Epsilon financial statements and the pro forma FY3 income statement present Iota's financial statements. This would enable investors to see the financial performance of the business undertaking that in essence is to be the subject in which investors are to invest. (Option 3C)
- Present special purpose financial information that excludes the results and assets of Zeta by treating them as part of the previous shareholders' equity. (Option 3D)
- Present special purpose consolidated financial information for Epsilon showing Zeta as a discontinued operation throughout the track record period. (Option 3E)

It might also be appropriate to include a pro forma income statement for FY3 illustrating the effect of the disposal of together Zeta from Epsilon as if it had happened at the beginning of that year.

PwC view

The cleanest presentation may well be presenting special purpose financial information that excludes Zeta, Option 3D. Indeed, this may be the only practicable solution where Epsilon does not have access to the historic records of Zeta following its disposal. However, this approach is predicated on the financial information of Zeta being complete, discrete and separate from Iota such that it can be argued that Epsilon acts more as investment holding entity.

Option 3E might be more attractive on a cost benefit basis than Option 3D although the use of a discontinued operations approach would only give the effect of the disposal on the income statement as Zeta would be fully consolidated in the balance sheet.

Options 3A, or 3B or 3C if the impact of Zeta's disposal was quite significant, would be more appropriate where Epsilon is already traded on a regulated market.

Extra thoughts

- Would the answer differ if the disposal of Zeta had occurred in the middle or first year of the three year financial history period?
- What if Iota and/or Zeta had not been IFRS reporters, as would be permitted under EU law?
- What if Epsilon elects to only present FY2 and FY3 on an IFRS basis, presenting FY1 and, following CESR's Recommendations, FY2 on its previous EU national GAAP basis?
- What if there was more than one disposal in the track record period?
- Would the answer differ if the prospectus were being issued in connection with a further issue of securities by a company already traded on an EU regulated market and would the proportion of new shares being issued matter?
- What if Zeta and Iota had been under common operational management?

4 A de-merger or division from an existing group

Fact pattern

Lambda is currently traded on an EU regulated market. It has a distinct business undertaking Tau, Lambda intends to separate out Tau and secure a separate listing for Tau under a new holding company on an EU regulated market. Tau was shown in Lambda's financial statements as a separate segment in each of Lambda's last three year's financial statements.

Whilst the companies that comprised Tau were all owned and controlled by Lambda, directly or indirectly throughout the last three financial years they were not constituted as a legal sub-group. Prior to the separation, or de-merger, Lambda will undergo an internal re-organisation that will enable the new holding company to acquire the Tau business undertaking prior to its admission to trading.

What financial information should be presented in the prospectus?

Does a complex financial history or significant financial commitment exist?

Irrespective of when the new Tau holding company acquires the Tau business undertaking, whether prior to the date of the prospectus, or after the drawing up of the prospectus, the new Tau holding company self-evidently would have either a complex financial history or entered into a significant financial commitment.

The key issue is therefore determining a financial history for the Tau business undertaking.

- One option would be to consider the existing financial information available for the business undertaking of Tau or entities within it. This might comprise one or more sets of financial information which could be presented in the prospectus of the new holding company. These could then be supplemented by pro forma financial information for FY3 combining the new holding company with the separate information for the Tau business undertaking entities. (Option 4A)

- An alternative option is to present a single financial record for the Tau business undertaking as if it had been separately constituted throughout the last three financial years. Such financial information is often described as ‘carve-out’ financial statements. It would also be appropriate to consider including pro forma financial information to illustrate the impact on the new holding company’s balance sheet of acquiring the Tau business undertaking. (Option 4B)

Analysis

Option 4A has the attraction of delivering a financial record at the least cost to the issuer as it uses previously published financial statements.

Option 4B has the benefit of providing a single clean record of the Tau business undertaking on the basis of which investors can make an informed assessment. However, the benefit of this might be the most expensive to achieve. This option also requires the auditor to be able to report that such combined, or what is often termed ‘carve-out’, financial information shows a true and fair view. This can create some challenges where the required accounting framework, such as IFRS, does not explicitly address such questions although presenting such financial information is common market practice. Combined, or ‘carve-out’, financial statements are sometimes described as ‘pro forma’. This should not be confused with the definition of pro forma financial information within the Prospectus Regulation.

PwC view

The best presentation of Tau’s business would be for combined financial information to be presented in the prospectus (Option 4B). Whilst the preparation of combined financial information can present practical challenges, the likelihood of a relatively simple alternative solution set as suggested in Options 4A is unlikely to occur in practice.

Extra thoughts

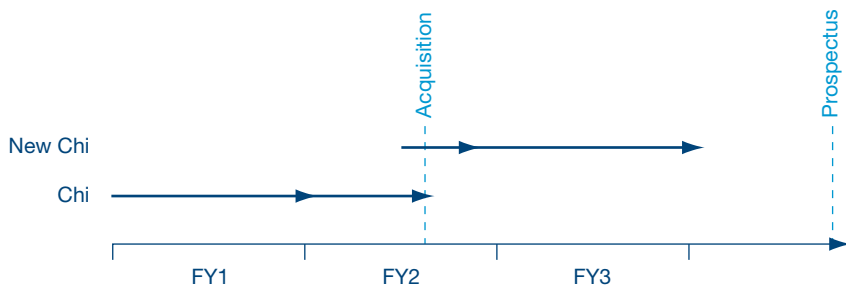
Challenges might arise if:

- The businesses forming Tau were not constituted in separate legal entities or sub-groups but were part of entities or sub-groups that also carried out business being retained by Lambda;
- There are a large number of entities on which separate financial information is available to be included;
- Lambda had undergone internal re-organisations through the past the years affecting the legal sub-groups that are to be transferred to the Tau holding company:
 - the legal sub-groups have included entities that have been disposed of in the three year period;
 - consolidated financial statements at the legal sub-group level have not been prepared; or
- The financial statements of the entities within the Tau business undertaking might have been prepared in their domestic GAAP.

5 A private equity backed acquisition in the three year history

Fact pattern

In the second year of the last three financial years Chi was the subject of an acquisition financed by a private equity house through a new holding company New Chi. The underlying business undertaking of Chi has continued unchanged throughout those three years. New Chi is to be the subject of an initial public offer and admission to trading of its shares on a regulated market.



Analysis

As the issuer, New Chi has entered into a transaction in FY2 that means that its entire business undertaking is not accurately presented for the three financial years. Consequently, New Chi has a complex financial history.

What financial information should be presented in the prospectus?

- One route is to present separately the consolidated statutory accounts of New Chi for the part of FY2 and for FY3 and special purpose financial information for Chi for FY1 and FY2 through to the date of its acquisition by New Chi. (Option 5A)
- If it is not possible to prepare special purpose financial information for Chi as at the date of its acquisition by New Chi, the statutory accounts of Chi for both FY1 and FY2 could be presented, if they exist. (Option 5B)
- Special purpose financial information combining the results of Chi and New Chi in one single set of financial information could be prepared. This is consistent with historic practice in a number of international markets including the United States, the United Kingdom and Italy. (Option 5C)

PwC view

Our view is that the most beneficial presentation is that of a combined predecessor and successor record, Option 5C, as this reflects the fact that the underlying trading of the Chi business undertaking has continued throughout the three financial years and that the acquisition was effectively a financial transaction.

Extra thoughts

The impact of any fair value adjustments made on the acquisition of Chi on the post-acquisition income statement needs to be considered as regards the disclosure in any combined financial information – it may be that a ‘black line’ approach distinguishing between the pre- and post-acquisition periods is desirable.

PricewaterhouseCoopers Capital Markets Groups

Our network of Capital Market Groups across Europe comprise specialists who provide a broad range of services to companies and investment banks in connection with the capital market transactions, including:

- Preparation for becoming a public company;
- Selecting the right market and advisory team;
- Advising on regulatory issues;
- Undertaking financial and business due diligence investigations; and
- Assisting with GAAP conversion projects.

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