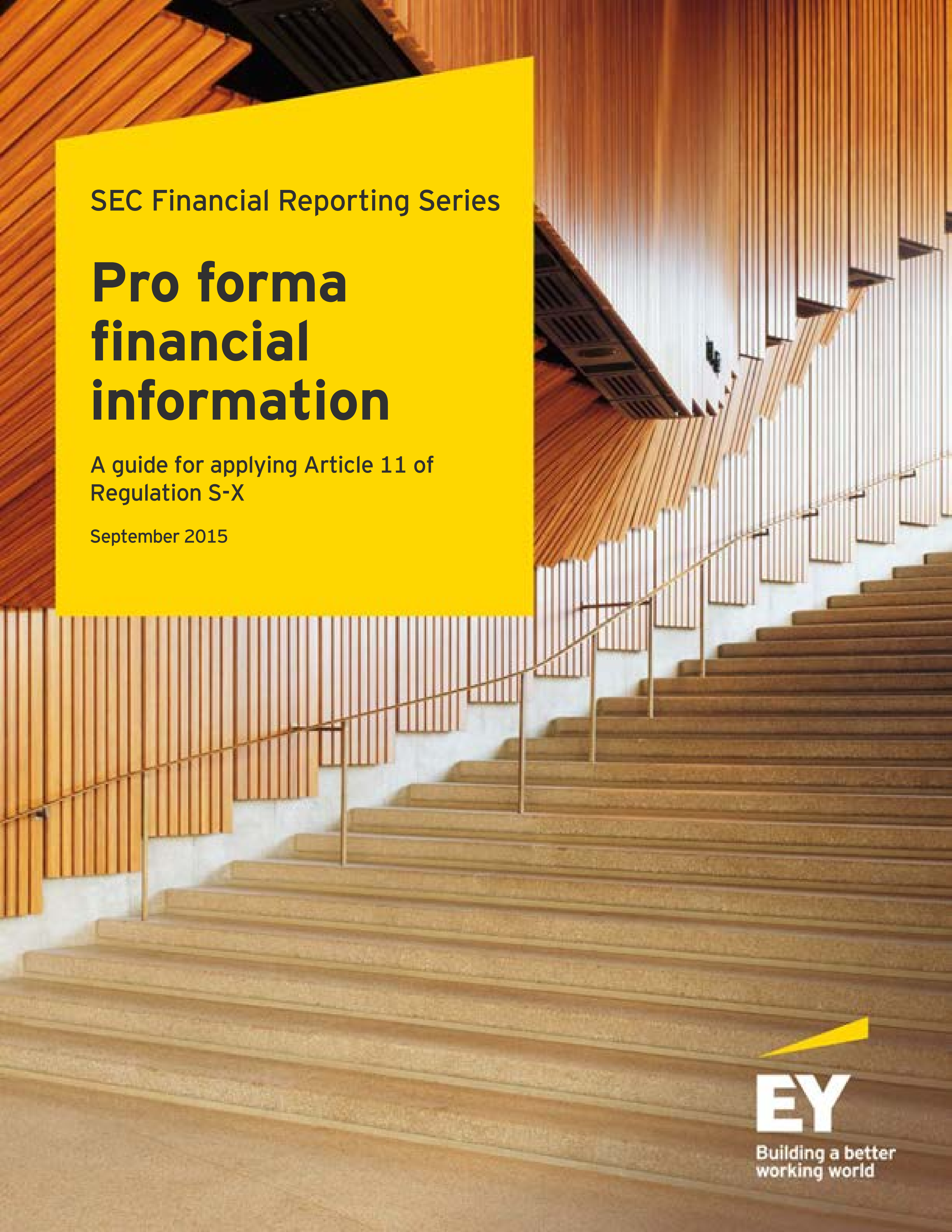
SEC Financial Reporting Series

Pro forma financial information

A guide for applying Article 11 of Regulation S-X

September 2015



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Contents

1 Overview

We are pleased to present the first edition of our publication, *Pro forma financial information — A guide for applying Article 11 of Regulation S-X*. Pro forma financial information (pro forma financial statements or pro formas) presents historical balance sheet and income statement information adjusted as if a transaction had occurred at an earlier time. This information is intended to help investors understand the impact of a significant transaction, such as a business combination or disposition, by showing how it might have affected the historical financial statements.

Article 11 of Regulation S-X, *Pro forma financial information* (Article 11 or S-X Article 11) describes the requirements of the Securities and Exchange Commission (SEC) for registrants to provide pro forma financial information. In addition, Article 8-05 of Regulation S-X provides the SEC's pro forma requirements for smaller reporting companies (SRCs) that have significant business acquisitions.[1] While our publication focuses on the requirements of Article 11, the principles we discuss could also be applicable to SRCs when they prepare pro forma financial information under Article 8 of S-X.

1.1 Section highlights

The following is an overview of the sections in this publication:

- Section 2 describes the events and circumstances that would require registrants to present Article 11 pro forma financial information in SEC filings.
- Section 3 discusses which SEC forms require Article 11 pro forma financial information.
- Section 4 walks through the general form and content requirements for pro forma financial information.
- Section 5 covers the pro forma financial statement periods that registrants must provide.
- Section 6 focuses on pro forma adjustments and illustrates through examples how registrants may apply the adjustment criteria.
- Section 7 highlights other considerations, including certain pro forma metrics (e.g., earnings per share), Form S-4 pro forma requirements and pro forma management's discussion and analysis (MD&A).
- Section 8 covers auditors' responsibilities and their involvement with respect to pro forma financial information.
- Our Appendix provides a comprehensive set of pro forma financial statements.

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[1] Note 2 to Article 8 of S-X states that SRCs may wish to consider the guidance in Article 11-01 of S-X to the extent that it provides additional guidance for preparation of pro forma financial information.

1.2 EY publications and checklists

Our publications and checklists provide interpretive guidance and assistance in preparing various SEC forms and schedules. These documents are available from any EY representative.

- *SEC Comments & Trends (*SCORE No. CC0398*)* — This publication discusses the SEC staff's comments on public company filings to provide insights on the SEC staff's concerns and areas of focus, including those related to pro forma financial information.
- *Form 10-K and registration statement checklist supplement to GAAP disclosure checklist*. Parts I through III of the checklist assist in determining whether various Regulation S-X and S-K requirements in registration statements have been satisfied; Part III includes a section on Article 11 pro forma financial information (EY Form A69).

1.3 Other considerations

Our publication is not a substitute for reading Article 11 of Regulation S-X or the applicable form instructions that require Article 11 pro forma financial statements. Readers also should consider the views of the SEC and its staff that are included in the following documents (among others):

- Financial Reporting Releases (FRs) and The Codification of Financial Reporting Policies (FRC)
- Staff Accounting Bulletins
- The Division of Corporation Finance's Financial Reporting Manual (FRM)
- The Center for Audit Quality (CAQ) SEC Regulations Committee meeting highlights

FRs sometimes adopt revisions to Regulation S-X. The FRC contains selected content from Accounting Series Releases (ASRs) and FRs regarding the SEC's expectations and basis for its rulemaking.

Staff Accounting Bulletins (SAB) provide written accounting interpretations and practices followed by the SEC's Division of Corporation Finance and Office of the Chief Accountant. SAB Topic 1.B addresses certain pro forma requirements that primarily are relevant in initial public offering (IPO) registration statements. While SABs are not official SEC rules or regulations, they do reflect administrative positions the SEC staff expects registrants to follow.

The FRM[2] is designed to be an internal reference document and to provide general guidance only to Division of Corporation Finance staff. The SEC staff's interpretations and guidance about Article 11 pro forma financial information are included in Topic 3 of the FRM.

The SEC Regulations Committee meets periodically with the SEC staff to discuss emerging financial reporting issues relating to SEC rules and regulations, which then are summarized in the meeting highlights available on the CAQ website. The highlights have not been considered and acted upon by senior technical committees of the American Institute of Certified Public Accountants (AICPA) or by the Financial Accounting Standards Board (FASB) and do not represent an official position of either organization. They also are not authoritative positions, interpretations or official statements of the SEC or its staff. However, registrants should consider the views of the SEC staff when preparing SEC filings.

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[2] The FRM's front cover contains a disclaimer that "it is designed to be an internal reference document and to provide general guidance only to Division staff." However, because the information in the FRM has been useful to registrants and their auditors, the SEC staff has posted it to the SEC's website at the following link: http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml.

1.3.1 ASC 805 pro forma requirements

Accounting Standards Codification (ASC) 805-10-50-2(h) requires registrants to disclose certain pro forma information in the footnotes of a public business entity's financial statements when that entity has completed a material business combination. ASC 805 requires pro forma revenue and earnings to be disclosed as if the business combination had occurred at the beginning of the prior annual period when comparative financial statements are presented. Companies also must provide a narrative description of the nature and amount of material nonrecurring adjustments.

These pro forma disclosures are different from and substantially less detailed than the information required in a set of Article 11 pro forma financial statements. However, because ASC 805 does not provide guidance on how entities should calculate pro forma revenue and earnings, the principles in Article 11 may be helpful in preparing the ASC 805 pro forma disclosures.

It is also important to note that the evaluation of materiality for purposes of including ASC 805 pro forma information is separate and different from the significance tests performed for the purposes of presenting Article 11 pro forma financial information. In other words, supplemental pro forma disclosures under ASC 805 may still be necessary even when Article 11 pro forma financial information is not required.

Refer to our publication, *Financial reporting developments, Business combinations*, for more information about the pro forma requirements in ASC 805.

1.3.2 Pro forma financial information in non-SEC offering documents

Registrants may include pro forma financial information in offering documents other than registration statements under the Securities Act of 1933 (Securities Act or 1933 Act) or Exchange Act of 1934 (Exchange Act or 1934 Act). Financial statements and other information (including pro forma financial information) included in such offering documents (e.g., exempt offering memoranda for Rule 144A offerings) are not bound by SEC form instructions or the requirements of Regulation S-X. Instead, third-party broker-dealer(s) or financial intermediaries associated with the offering determine what information should be provided. Therefore, the requirements in Article 11 of Regulation S-X discussed in this publication do not have to be followed in non-SEC offering documents. However, the principles in Article 11 and the discussions in this publication may be helpful to provide a framework for preparing pro forma financial information in non-SEC offering documents.

2 Events requiring pro forma financial information

2.1 Overview

This section describes the events and circumstances in which Article 11 pro forma financial statements should be presented in filings with the SEC.

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro forma financial information

Rule 11-01, Presentation requirements

(a) Pro forma financial information shall be furnished when any of the following conditions exist:

(1) During the most recent fiscal year or subsequent interim period for which a balance sheet is required by Regulation S-X Rule 3-01 , a significant business combination has occurred (for purposes of these rules, this encompasses the acquisition of an interest in a business accounted for by the equity method);

(2) After the date of the most recent balance sheet filed pursuant to S-X Rule 3-01, consummation of a significant business combination or a combination of entities under common control has occurred or is probable;

(3) Securities being registered by the registrant are to be offered to the security holders of a significant business to be acquired or the proceeds from the offered securities will be applied directly or indirectly to the purchase of a specific significant business;

(4) The disposition of a significant portion of a business either by sale, abandonment or distribution to shareholders by means of a spin-off, split-up or split-off has occurred or is probable and such disposition is not fully reflected in the financial statements of the registrant included in the filing;

(5) During the most recent fiscal year or subsequent interim period for which a balance sheet is required by S-X Rule 3-01, the registrant has acquired one or more real estate operations or properties which in the aggregate are significant, or since the date of the most recent balance sheet filed pursuant to that section the registrant has acquired or proposes to acquire one or more operations or properties which in the aggregate are significant;

(6) Pro forma financial information required by Regulation S-K Item 914 is required to be provided in connection with a roll-up transaction as defined in Regulation S-K Item 901(c);

(7) The registrant previously was a part of another entity and such presentation is necessary to reflect operations and financial position of the registrant as an autonomous entity; or

(8) Consummation of other events or transactions has occurred or is probable for which disclosure of pro forma financial information would be material to investors.

2.2 Types of events requiring Article 11 pro forma financial information

Article 11 pro forma financial information is required when events occur or conditions exist for which disclosure would be material to investors. Companies must present Article 11 pro forma financial information when certain transactions occur, including:

- Significant business acquisition or probable acquisition
- Disposition or probable disposition of a significant business
- Acquisition of significant real estate operations
- Roll-up transactions
- Spin-offs

This list does not include every event or transaction for which disclosure of Article 11 pro forma information would be material to investors. The SEC believes it is impossible to consider all situations where pro forma financial information should be presented. Therefore, its rules are intentionally broad. Management must determine whether pro forma financial information would be meaningful to investors based on the facts and circumstances of a transaction.

Section 3 of this publication discusses the SEC forms and filings that require pro forma financial information.

2.2.1 Significant business combination and disposition

Article 11 pro forma financial information is required if a significant business combination is probable or has occurred in the latest fiscal year or subsequent interim period. This includes any transaction or event that results in the registrant obtaining control over another entity (e.g., consolidation by contract) as well as the acquisition of a significant equity method investment.

Article 11 pro forma financial information is required if a disposition either by sale, abandonment or distribution to shareholders has occurred or is probable. The significance of a business acquisition or disposition is defined in Article 11 of Regulation S-X as follows:

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro forma financial information

Rule 11-01, Presentation requirements

(b) A business combination or disposition of a business shall be considered significant if:

(1) A comparison of the most recent annual financial statements of the business acquired or to be acquired and the registrant's most recent annual consolidated financial statements filed at or prior to the date of acquisition indicates that the business would be a significant subsidiary pursuant to the conditions specified in Regulation S-X Rule 1-02(w), substituting 20 percent for 10 percent each place it appears therein; or

(2) The business to be disposed of meets the conditions of a significant subsidiary in Regulation S-X Rule 1-02(w).

Refer to Section 2.2.1.2 below for a description of the significance tests under S-X Rule 1-02(w).

In general, for business acquisitions, whenever audited historical financial statements of the acquired business are required, Article 11 pro forma financial information also must be presented. Article 11 pro forma information also may be necessary if an acquiree of the registrant consummated a significant business combination of its own during the year (i.e., a second-tier acquisition) if that information would be material for investors to understand the registrant or vote on a transaction.

The SEC staff considers the presentation of an acquiree's financial statements without accompanying pro forma information to be misleading. Likewise, pro forma financial information is not required to be presented for a business acquisition if separate statements are not required in the filing. Article 11 pro forma presentation is not required if the transaction is already reflected in the registrant's financial statements for a full fiscal year.

2.2.1.1 Determination of what constitutes a business

An acquisition constitutes the acquisition of a business if, after evaluating all available facts and circumstances, there is sufficient continuity of operations so that disclosure of prior financial information is material to an understanding of future operations. There is a presumption that a separate entity, subsidiary, division or investment accounted for under the equity method is a business.

The acquisition of a component of an entity, such as a product line, also may be considered a business. In evaluating whether a component of an entity is a business, registrants should consider the criteria in Article 11-01(d) of Regulation S-X such as whether the nature of the revenue-producing activity or other attributes of the component will remain the same as before the transaction.

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro forma financial information

Rule 11-01, Presentation requirements

(d) For purposes of this rule, the term business should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity's operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business. However, a lesser component of an entity may also constitute a business. Among the facts and circumstances which should be considered in evaluating whether an acquisition of a lesser component of an entity constitutes a business are the following:

(1) Whether the nature of the revenue-producing activity of the component will remain generally the same as before the transaction; or

(2) Whether any of the following attributes remain with the component after the transaction:

(i) Physical facilities,

(ii) Employee base,

(iii) Market distribution system,

(iv) Sales force,

(v) Customer base,

(vi) Operating rights,

(vii) Production techniques, or

(viii) Trade names.

Because these guidelines are not all-inclusive, management must use judgment in this area. The SEC staff's analysis of whether an acquisition constitutes the acquisition of a business, rather than an acquisition of assets, focuses primarily on whether the nature of the revenue producing activity associated with the acquired assets will remain generally the same after the acquisition. This definition of a business differs from the US GAAP definition in ASC 805, *Business Combinations*; therefore, it is possible to reach a different conclusion about whether a business has been acquired under Article 11 and ASC 805.

2.2.1.2 Determining significance

The significance of an acquired or to be acquired business is based on the "significant subsidiary" tests specified in S-X Rule 1-02(w).

Excerpt from SEC rules and regulations

Regulation S-X, Article 1 Application of Regulation S-X

Rule 1-02, Definitions of terms used in Regulation S-X

(w) Significant subsidiary. The term significant subsidiary means a subsidiary, including its subsidiaries, which meets any of the following conditions:

(1) The registrant's and its other subsidiaries' investments in and advances to the subsidiary exceed 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year (for a proposed combination between entities under common control, this condition is also met when the number of common shares exchanged or to be exchanged by the registrant exceeds 10 percent[1] of its total common shares outstanding at the date the combination is initiated); or

(2) The registrant's and its other subsidiaries' proportionate share of the total assets (after intercompany eliminations) of the subsidiary exceeds 10 percent[1] of the total assets of the registrants and its subsidiaries consolidated as of the end of the most recently completed fiscal year; or

(3) The registrant's and its other subsidiaries' equity in the income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principle of the subsidiary exclusive of amounts attributable to any noncontrolling interests exceeds 10 percent[1] of such income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year.

Note to paragraph (w): A registrant that files its financial statements in accordance with or provides a reconciliation to U.S. Generally Accepted Accounting Principles shall make the prescribed tests using amounts determined under U.S. Generally Accepted Accounting Principles. A foreign private issuer that files its financial statements in accordance with IFRS as issued by the IASB shall make the prescribed tests using amounts determined under IFRS as issued by the IASB.

Computational note: For purposes of making the prescribed income test the following guidance should be applied:

1. When a loss exclusive of amounts attributable to any noncontrolling interests has been incurred by either the parent and its subsidiaries consolidated or the tested subsidiary, but not both, the equity in the income or loss of the tested subsidiary exclusive of amounts attributable to any noncontrolling interests should be excluded from such income of the registrant and its subsidiaries consolidated for purposes of the computation.

2. If income of the registrant and its subsidiaries consolidated exclusive of amounts attributable to any noncontrolling interests for the most recent fiscal year is at least 10 percent lower than the average of the income for the last five fiscal years, such average income should be submitted for purposes of the computation. Any loss years should be omitted for purposes of computing average income.

3. Where the test involves combined entities, as in the case of determining whether summarized financial data should be presented, entities reporting losses shall not be aggregated with entities reporting income.

[1] The significant subsidiary tests in Regulation S-X Rule 1-02(w) is referenced in several SEC rules and regulations and the threshold to determine significance may vary from one rule to another. For example, under Regulation S-X Rule 3-05 and for Article 11, an acquired business is significant when the results of any of the three significance tests (i.e., asset, investment and income) exceeds 20%.

Significance should be determined by comparing the most recent annual pre-acquisition financial statements of the acquired business, or group of related businesses, to the registrant's most recent annual pre-acquisition audited financial statements filed with the SEC under the following three significance tests:

- Asset test — Compare the registrant's share of the acquired business' total assets to the registrant's consolidated total assets.
- Investment test — Compare the total US GAAP purchase price of the acquired business to the registrant's consolidated total assets.
- Income test — Compare the registrant's pro rata share of the acquired business's income from continuing operations before taxes, extraordinary items[3] and cumulative effect of a change in accounting principle (net of noncontrolling interest) to that of the registrant.

The numerator and denominator of the significance tests must be computed using the acquirer's basis of accounting (e.g., US GAAP). The results of the significance tests must not be rounded. If the acquirer's consolidated income or the absolute value of its loss from continuing operations before income taxes, extraordinary items[3] and cumulative effect of a change in accounting principle, net of amounts attributable to any noncontrolling interests for the most recent year, is at least 10% less than the average of the last five fiscal years (substituting zero for any loss years in the numerator, but still using five as the denominator), the average should be substituted as the denominator in the income test. If an acquisition is made after reporting a previous significant acquisition or disposition on Form 8-K or a registration statement (other than an initial public offering or IPO) that includes all required information, significance may be evaluated using the acquirer's pro forma financial information rather than its historical financial statements.

[3] The FASB issued ASU 2015-01, *Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*, eliminating extraordinary items from US GAAP. For calendar year-end entities, the guidance is effective for interim and annual periods beginning in 2016. Early adoption is permitted, but adoption must occur at the beginning of the year. Entities can elect to apply the guidance prospectively or retrospectively.

2.2.1.3 Related businesses

The acquisition of related businesses must be treated as a single business acquisition. Businesses are considered related if they are either:

- Under common control or management
- Dependent on each other or a single common event or condition

For the purposes of aggregating related businesses to determine significance, companies should include acquisitions that occur in the latest fiscal year and any interim period subsequent to year end prior to the filing of the audited financial statements for the most recent year. While the related businesses are combined for purposes of determining significance, the financial statements of the related businesses may be presented on a combined basis only if they are under common control or common management as specified in ASC 810, *Consolidation*.

2.2.1.4 Individually insignificant acquisitions

Article 11 pro forma financial statements are not required for individually insignificant businesses unless the aggregate of any of the three significance tests (i.e., the asset, investment or income tests) exceeds 50% for acquisitions that have occurred or are probable since the most recent audited balance sheet date. In this circumstance, under Regulation S-X 3-05, *Financial statements of businesses acquired or to be acquired*, a registrant is required to provide audited financial statements for those individually insignificant acquisitions or probable acquisitions that constitute a mathematical majority (i.e., greater than 50%) of the aggregate asset, income or investment test determined to be the most significant.

For purposes of providing Article 11 pro forma financial statements, registrants are only required to include pro forma financial information for acquisitions for which they have provided financial statements. Even though audited financial statements are not required for all the individually insignificant acquisitions, registrants should consider whether the pro forma financial information would be misleading without giving effect to all individually insignificant acquisitions. We also believe registrants should carefully consider their facts and circumstances when evaluating whether it is appropriate to include some, but not all, of the individually insignificant acquisitions for which financial statements have not been provided.

If a registrant voluntarily provides the financial statements of an individually insignificant acquisition, the SEC staff encourages the registrant to also include Article 11 pro forma financial information in its SEC filing.[4]

2.2.1.5 Disposition or probable disposition of a significant business

Article 11 pro forma financial information is required whenever the business to be disposed of meets any of the "significant subsidiary" tests (i.e., the asset, investment and income tests) at the 10% level. The SEC staff has said that for purposes of applying the investment test to the disposition of a business, the numerator should be the higher of the consideration received for the portion of the business that is disposed of or the carrying value of the disposed business as of the end of the registrant's most recently completed fiscal year prior to the disposal date. For purposes of the asset test, the numerator should be the total assets of the disposed business as of its most recently completed fiscal year prior to disposal. The denominator of the investment and asset tests should be the registrant's total assets as of the end of its most recently completed fiscal year, which will include assets related to both its continuing and discontinued operations. For purposes of the income test, the numerator should be the pre-tax income or loss from continuing operations of the disposed business for its most recently completed fiscal year prior

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[4] SEC staff's Financial Reporting Manual Section 3110.

to the disposal. The denominator of the income test should be the registrant's historical pre-tax income or loss from continuing operations for its most recently completed fiscal year prior to the disposal. The denominator of the income test should not include the results of the disposed business if it already has been reported as a discontinued operation because S-X Rule 1-02(w) specifies that the denominator must equal the registrant's pre-tax income or loss from continuing operations.

Article 11 pro forma financial information also may be necessary if the disposition is material, even if the disposed operations do not meet the criteria in ASC 205-20, *Discontinued Operations*. Refer to Chapter 3.1 for additional considerations on the specific requirements of Form 8-K in reporting dispositions.

2.2.2 Acquisition of significant real estate operations

Form 8-K requires Article 11 pro forma financial information of real estate acquisitions of individually significant (greater than 10%) properties made after the end of the most recent fiscal year for which the registrant's financial statements have been filed and for significant acquisitions that are probable. For this purpose, properties that are related properties must be combined and evaluated. Refer to Section 2.2.1.3 for further discussion of related businesses. In some cases, registrants may file a "blind pool" registration statement with the SEC to sell securities to purchase real estate operations that are not identified at the effective date of the registration statement. Article 11 pro forma financial information of significant properties acquired during the blind pool distribution period should be provided in a current report on Form 8-K.

2.2.2.1 Acquisition of individually insignificant real estate operations

Generally, acquisitions of real estate operations that do not exceed 10% of total assets are considered individually insignificant. Under Regulation S-X 3-14, *Special instructions for real estate operations to be acquired*, a registrant is required to evaluate whether the aggregate of all insignificant real estate properties exceeds the 10% threshold, and if so, the registrant may need to file audited financial statements for each acquisition that is at least 5% significant. Further, the registrant should determine whether it has filed financial statements for individually insignificant acquisitions that together exceed 50% of the aggregate purchase price. If this threshold is not met, the registrant should file financial statements of acquisitions that are individually insignificant below the 5% threshold until financial statements for more than 50% of the aggregate purchase price have been filed. To compute significance, registrants must combine the following:

- Individually insignificant properties acquired after the end of the most recently completed fiscal year for which the registrant's audited financial statements are on file
- Individually insignificant probable acquisitions

If a registrant provides the financial statements of individually insignificant acquisition(s), the SEC staff requires the registrant to also include Article 11 pro forma financial information in its SEC filing with respect to such acquisition(s). For purposes of providing Article 11 pro forma financial statements, even though audited financial statements are not required for all the individually insignificant acquisitions, registrants should consider whether the pro forma financial information would be misleading without giving effect to all individually insignificant acquisitions.

2.2.3 Spin off or split off of a portion of an entity

Article 11 pro forma information may be necessary to reflect the operations and financial position of a registrant that was previously part of another entity as a standalone entity after a transaction commonly referred to as a "spin-off." In this case, the historical financial statements do not reflect the operations of the ongoing entity. The pro forma balance sheet should include pro forma adjustments to remove assets and liabilities that are not part of the spin-off. In addition, the effects of major distribution agreements, cost-sharing or management agreements and compensation or benefit plans should be reflected if the amounts are factually supportable, directly attributable to the transaction and expected to have a continuing effect on the statement of operations.

2.2.4 Other circumstances requiring pro forma information

Disclosure of Article 11 pro forma information may be material to investors if the following events or transactions have occurred or are probable:

- Entering into new or modified contracts that render historical financial statements not indicative of the ongoing entity (Refer to Section 6.2.7, *New or modified contractual arrangements*, for further discussion.)
- Declaring dividends after the balance sheet date (Refer to Section 7.1.1, *Planned distributions not reflected in the historical balance sheet,* and Section 7.1.2, *Distribution in excess of earnings,* for further discussion.)
- Changes in capitalization at or prior to closing of an IPO (Refer to Section 7.1.4, *Other changes in capitalization,* for further discussion.)
- Changes in tax status such as converting a subchapter S corporation or partnership to a C-corporation (Refer to Section 7.1.3, *Changes in tax status*, for further discussion.)
- Roll-up transaction (Refer to Section 7.3, *Rollup transactions*, for further discussion.)
- Receipt and application of offering proceeds (Refer to Section 6.2.8.4, *Use of proceeds*, for further discussion.)
- Repayment or refinancing of debt (Refer to Section 6.2.1.4, *Debt financing*, for further discussion.)
- Emergence from bankruptcy (Refer to Section 6.2.6, *Emergence from bankruptcy*, for further discussion.)

3 Forms requiring pro forma financial information

Generally, pro forma financial information is required in Form 8-K, registration statements and proxy statements, when applicable. Periodic reporting Forms 10-K and 10-Q do not require Article 11 pro forma information.

3.1 Form 8-K

Form 8-K requires pro forma financial information under Article 11 or Rule 8-05 of Regulation S-X for significant business combinations (including the acquisition of an equity method investment) and dispositions that are required to be described by Item 2.01 of Form 8-K. The Form 8-K is due within four business days of completion of the transaction.

If a registrant is unable to provide the required pro forma financial information for an acquisition when the Form 8-K is filed (e.g., because audited financial statements of the acquired business are not available), an automatic extension of 71 calendar days is available (Form 8-K Item 9.01(4)). As noted in Section 2.2.1, the SEC staff has said that Article 11 pro forma financial information should accompany the audited financial statements of an acquired business because an acquiree's standalone financial statements without the associated pro forma information may be misleading.

The 71-day extension allowed by Item 9.01(4) of Form 8-K does not apply to the requirement to file pro forma financial information for other transactions such as dispositions. That is, the pro forma financial information reflecting a significant disposition must be provided within four business days of its completion.

In an exchange transaction, the registrant and another party contribute businesses to a joint venture (e.g., Newco) in exchange for an equity interest. If pro forma financial information is required for both the disposition and the acquisition, a registrant may be unable to present a pro forma income statement depicting the joint venture formation at the time of the initial Form 8-K filing because the financial statements of the business contributed by the other party are not available.

These financial statements and related pro forma financial statements do not need to be filed until 71 calendar days after the date that the initial report of the transactions on Form 8-K is filed (i.e., four business days after the transaction is consummated plus 71 calendar days). Pro forma financial statements depicting a significant disposition are ordinarily filed within four business days of the disposition. The SEC staff will not object if the initial Form 8-K reporting the transaction includes a description of the effects of the disposition and quantifies those effects, if practicable. The complete pro forma information depicting the effects of the exchange of interests should be filed at the time that the audited financial statements of the acquired business are filed.

3.2 Registration statements and proxy statements

Article 11 pro forma financial information must be provided in registration statements and certain proxy statements when a significant transaction or event meeting the guidelines in Section 2 has occurred or is probable and the income statement for the most recent fiscal year does not reflect the transaction for the entire period.

Refer to Section 7.4, *Additional Form S-4 and proxy statement pro forma requirements*, for a discussion of other pro forma financial information that may be required in these filings.

Registration statements

The following table outlines the pro forma requirements for the most common domestic registration statements:

Illustration 3-1: Domestic registration statement requirements for pro forma financial information

Registration statement		Pro forma financial information required?	Form Item
Form S-1		Yes — Pro forma disclosures must be provided, when applicable.	Item 11(e)
Form S-3		Yes — Registrants[5] may choose to: ▸ Include pro forma information in the Form S-3 prospectus ▸ Incorporate pro forma information by reference into the Form S-3 prospectus from: (1) A recent 1934 Act filing, such as Form 8-K (2) A proxy or information statement (3) A previously filed prospectus	Item 11(b)(i)
Form S-4		Yes — Pro forma disclosures relating to the transaction must be included in the prospectus.	Item 5
Form S-4		The registrant and/or the company being acquired may have to present pro forma information unrelated to the transaction for which securities are being registered in the Form S-4.[6]	Item 10(b) and Item 12(c)
Form S-8		No — Pro forma disclosures are not required.	N/A
Form S-11		Yes — Pro forma disclosures must be provided in the prospectus, when applicable.	Item 27
Form 10		Yes — Pro forma disclosures must be provided, when applicable.	Item 13

[5] To maintain an active shelf registration statement on Form S-3, a registrant generally must provide pro forma financial information on a current and timely basis because a Form S-3 automatically incorporates all 1934 Act documents filed subsequent to the effective date of the Form S-3.

[6] Such unrelated pro forma information must be presented with, but clearly distinguished from, the pro forma information relating to the transaction. See Section 4.2.1 for additional discussion and an example about how to present multiple transactions.

Proxy statements

Proxy statements filed on Schedule 14A may require Article 11 pro forma information in Item 13 when the proxy statement is used to solicit a shareholder vote to:

- Authorize or issue additional securities under Item 11 of Schedule 14A (e.g., securities to be issued for cash in a public offering)
- Modify or exchange outstanding securities under Item 12 of Schedule 14A

Pro forma financial information may be omitted if it is not material to the exercise of prudent judgment. For example, Item 13 of Schedule 14A presumes pro forma information would be material to the decision to authorize or issue a material amount of senior securities. However, the information usually is not material if shareholders are being asked to authorize or issue common stock (except in an exchange, merger, consolidation, acquisition or similar transaction); authorize preferred stock that the registrant has no specific plans to issue; or authorize preferred stock for issuance for cash at fair value.

Pro forma information may be required in Item 14 of Schedule 14A if shareholders are voting on any transaction involving:

- The merger or consolidation of the registrant into or with any other company or of any other company into or with the registrant
- The acquisition by the registrant of securities of another company
- The acquisition by the registrant of any other business or of the assets of another business
- The sale or other transfer of all or any substantial part of the assets of the registrant
- The liquidation or dissolution of the registrant

The requirements for pro forma information (for the registrant and/or acquiree) in these circumstances under Item 14 are similar to the requirements in a Form S-4 filing, which are discussed above.

3.3 Foreign private issuer forms

Foreign private issuers (FPIs) do not have the same current reporting requirements as domestic registrants do on Form 8-K. Form 6-K is available for FPIs to furnish certain information to the SEC that is (1) made public or is required to be made public pursuant to the laws of the FPI's country of domicile or under which the FPI is incorporated, (2) filed with and made public by a stock exchange on which the FPI's securities are traded or (3) distributed to the FPI's security holders. Depending on the local law and stock exchange requirements, this information may include certain financial information about acquisitions or dispositions of assets or businesses. However, completed acquisitions or dispositions of assets and businesses by FPIs are not required to be reported under Item 2.01 of Form 8-K.

Pro forma financial information must be provided in or incorporated by reference into FPI registration statements (i.e., F-1, F-3, F-4, registration statements on Form 20-F) consistent with the respective requirements above for domestic registration statements. Similar to domestic registrants, FPIs are not required to provide pro forma financial information in annual reports on Form 20-F.

4 Format of pro forma financial information

4.1 General form and content

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro Forma Financial Information

Rule 11-02(b), Preparation Requirements, Form and content

(1) Pro forma financial information shall consist of a pro forma condensed balance sheet, pro forma condensed statements of income, and accompanying explanatory notes. In certain circumstances (i.e., where a limited number of pro forma adjustments are required and those adjustments are easily understood), a narrative description of the pro forma effects of the transaction may be furnished in lieu of the statements described herein.

(2) The pro forma financial information shall be accompanied by an introductory paragraph which briefly sets forth a description of (i) the transaction, (ii) the entities involved, and (iii) the periods for which the pro forma information is presented. In addition, an explanation of what the pro forma presentation shows shall be set forth.

(3) The pro forma condensed financial information need only include major captions (i.e., the numbered captions) prescribed by the applicable sections of this Regulation. Where any major balance sheet caption is less than 10 percent of total assets, the caption may be combined with others. When any major income statement caption is less than 15 percent of average net income attributable to the registrant for the most recent three fiscal years, the caption may be combined with others. In calculating average net income attributable to the registrant, loss years should be excluded unless losses were incurred in each of the most recent three years, in which case the average loss shall be used for purposes of this test. Notwithstanding these tests, de minimis amounts need not be shown separately.

(4) Pro forma statements shall ordinarily be in columnar form showing condensed historical statements, pro forma adjustments, and the pro forma results.

(5) The pro forma condensed income statement shall disclose income (loss) from continuing operations before nonrecurring charges or credits directly attributable to the transaction. Material nonrecurring charges or credits and related tax effects which result directly from the transaction and which will be included in the income of the registrant within the 12 months succeeding the transaction shall be disclosed separately. It should be clearly indicated that such charges or credits were not considered in the pro forma condensed income statement. If the transaction for which pro forma financial information is presented relates to the disposition of a business, the pro forma results should give effect to the disposition and be presented under an appropriate caption.

Pro forma financial information generally will consist of an introductory paragraph, pro forma balance sheet, pro forma income statement(s), and explanatory notes. Article 11 pro forma financial information does not require pro forma statements of comprehensive income, cash flows or shareholders’ equity.

Appendix A: Comprehensive Pro Forma Financial Information Example along with the illustrations in this chapter provide examples of the general presentation of pro forma financial information in accordance with Article 11 of Regulation S-X.

4.1.1 Introductory paragraph

The introductory paragraph should briefly explain what the pro forma information shows and describe the transaction, the entities involved, and the periods covered by the pro forma financial information. The pro forma financial information involves inherent limitations and assumptions that are frequently highlighted in the introductory paragraph. For example, the introductory paragraph often states that the pro forma financial information may not reflect the financial condition or operating results of the combined or reorganized entity or may not be useful in predicting its future condition and operating results.

Illustration 4-1: Introductory paragraph example

The following unaudited pro forma condensed combined financial statements are based on our historical consolidated financial statements and ABC Company's historical consolidated financial statements as adjusted to give effect to the 20 August 20X4 acquisition of ABC Company. The unaudited pro forma condensed combined statements of operations for the six months ended 30 June 20X4 and the 12 months ended 31 December 20X3 give effect to the acquisition of ABC Company as if it had occurred on 1 January 20X3. The unaudited pro forma condensed combined balance sheet as of 30 June 20X4 gives effect to the acquisition of ABC Company as if it had occurred on 30 June 20X4.

The pro forma combined financial statements do not necessarily reflect what the combined company's financial condition or results of operations would have been had the acquisition occurred on the dates indicated. They also may not be useful in predicting the future financial condition and results of operations of the combined company. The actual financial position and results of operations may differ significantly from the pro forma amounts reflected herein due to a variety of factors.

4.1.2 Presentation in columns

The pro forma financial information should be presented in columns, including columns for the following:

- Historical financial statements of the registrant
- Historical financial statements of the acquired business or divested business, if applicable
- Pro forma adjustments
- Pro forma results that reflect the sum of the historical financial statements and pro forma adjustments

Illustration 4-2: Columnar presentation example

Unaudited Pro Forma Condensed Combined Balance Sheet
As of 30 June 20X4
(In thousands)

	Registrant Historical	ABC Company (Acquiree) Historical	Pro Forma Adjustments	Notes	Pro Forma Combined
Cash and cash equivalents	$ 3,200	$ 1,400	–		$ 4,600
Accounts receivable, net	25,800	13,200	–		39,000
Other current assets	2,500	1,100	–		3,600
Total current assets	31,500	15,700	–		47,200
Property and equipment, net	28,300	11,300	2,100	(a)	41,700
Goodwill	12,900	5,400	8,800	(d)	27,100
Intangible assets, net	10,800	8,900	6,200	(b)	25,900
Total assets	$ 83,500	$ 41,300	$ 17,100		$ 141,900
Accounts payable	$ 23,400	$ 19,100	–		$ 42,500
Accrued liabilities and other current liabilities	4,800	1,500	–		6,300
Total current liabilities	28,200	20,600	–		48,800
Long-term debt	20,600	–	37,800	(c)	58,400
Total liabilities	48,800	20,600	37,800		107,200
Total shareholders' equity	34,700	20,700	(20,700)		34,700
Total liabilities and shareholders' equity	$ 83,500	$ 41,300	$ 17,100		$ 141,900

See accompanying notes to the Unaudited Pro Forma Condensed Combined Financial Information

Unaudited Pro Forma Condensed Combined Statements of Operations
Six Months Ended 30 June 20X4
(In thousands, except per share information)

	Registrant Historical	ABC Company (Acquiree) Historical	Pro Forma Adjustments	Notes	Pro Forma Combined
Revenue	$ 81,300	$ 37,000	–		$ 118,300
Costs of revenue, exclusive of depreciation and amortization	45,900	16,900	–		62,800
Depreciation and amortization expense	7,800	4,600	1,200	(e)	13,600
Selling, general and administrative expense	16,500	12,800	–		29,300
Operating income	11,100	2,700	(1,200)		12,600
Interest expense	800	–	1,700	(f)	2,500
Income before income taxes	11,900	2,700	(2,900)		11,700
Income tax provision (benefit)	3,000	900	(1,000)	(g)	2,900
Net income	$ 8,900	$ 1,800	$ (1,900)		$ 8,800
Basic and diluted earnings per share	$ 0.87				$ 0.86
Weighted-average shares	10,200				10,200

See accompanying notes to the Unaudited Pro Forma Condensed Combined Financial Information

Unaudited Pro Forma Condensed Combined Statements of Operations

Year Ended 31 December 20X3

(In thousands, except per share information)

	Registrant Historical	ABC Company (Acquiree) Historical	Pro Forma Adjustments	Notes	Pro Forma Combined
Revenue	$ 146,300	$ 63,000	–		$ 209,300
Costs of revenue, exclusive of depreciation and amortization	84,900	28,900	–		113,800
Depreciation and amortization expense	14,800	9,100	2,400	(e)	26,300
Selling, general and administrative expense	33,000	21,900	–		54,900
Operating income	13,600	3,100	(2,400)		14,300
Interest expense	1,600	–	3,400	(f)	5,000
Income before income taxes	15,200	3,100	(5,800)		12,500
Income tax provision (benefit)	4,500	1,100	(2,000)	(g)	3,600
Net income	$ 10,700	$ 2,000	$ (3,800)		$ 8,900
Basic and diluted earnings per share	$ 1.09				$ 0.91
Weighted-average shares	9,800				9,800

See accompanying notes to the Unaudited Pro Forma Condensed Combined Financial Information

4.1.2.1 Condensed format

A registrant may present pro forma financial information in condensed form similar to the presentation of interim financial statements under Article 10 of Regulation S-X. At most, account descriptions in the pro forma balance sheet and income statements must include the major, numbered captions in Regulation S-X (i.e., Rule 5-02 and 5-03). However, the major captions may be combined with others if certain criteria summarized below are met. See EY's publication, *SEC quarterly reports — Form 10-Q*, for further guidance on condensing financial information.

4.1.2.2 Pro forma condensed income statement

Companies should present the pro forma income statements only through income (loss) from continuing operations. If the historical financial statements report discontinued operations, extraordinary items or the cumulative effects of accounting changes, these items should be excluded from the pro forma income statement. Companies also should consider reflecting an allocation of earnings to noncontrolling interests on the face of the pro forma income statement, if applicable.

A registrant also must disclose, on the face of the pro forma income statement, basic and diluted earnings per share from continuing operations, and the number of shares used in the computation, on both the historical and pro forma basis.

4.1.2.3 Narrative disclosure only

In limited cases when there are only a few pro forma adjustments that are easy to understand, a registrant could provide a narrative description of the pro forma effects of the transaction instead of pro forma financial statements.

Illustration 4-3: Narrative disclosure only example

On 1 February 20X4, a registrant acquired the remaining 40% noncontrolling interest in a subsidiary that it already consolidated. Because the acquisition of the noncontrolling interest is significant to the registrant (i.e., greater than 20% significant based on the tests specified in Rule 1-02(w) of Regulation S-X), the registrant is required to include pro forma information on the acquisition of the additional interest in a Form 8-K by 16 April 20X4.

The pro forma adjustments are easy to understand and include reclassifying the noncontrolling interest within equity in the balance sheet and the income attributable to noncontrolling interest holders in the income statement. Therefore, the registrant may determine that a description of the nature and effect of the pro forma adjustments in narrative form is appropriate and full pro forma financial statements aren't necessary.

The registrant might provide the following narrative only disclosures related to the pro forma financial information:

Narrative description of the pro forma effects of the transaction

On 1 February 20X4, the Company acquired the remaining 40% noncontrolling interest in XYZ Inc., which is a consolidated subsidiary of the Company, for $100 million in cash.

If the transaction had occurred on 31 December 20X3, the pro forma balance sheet would have reflected a pro forma adjustment to reduce cash by $100 million and total shareholders' equity by $100 million (of which $90 million would reduce the carrying amount of the noncontrolling interest as of 31 December 20X3 and $10 million would reduce additional paid-in capital). As of 31 December 20X3, pro forma total assets and shareholders' equity would have been $385 million and $220 million, respectively.

If the transaction had occurred on 1 January 20X3, the pro forma income statement would have reflected a pro forma adjustment to reclassify the net income of $25 million attributable to noncontrolling interests to net income attributable to controlling interests. Pro forma net income attributable to controlling interests would have been $70 million for the year ended 31 December 20X4. Pro forma basic and diluted EPS would have increased $0.25 per share to $0.70 per share.

4.1.3 Pro forma adjustments and explanatory notes

Pro forma adjustments are material charges, credits and related tax effects that are directly attributable to the transaction and are factually supportable. Refer to chapter 6 for further discussion of the criteria for pro forma adjustments. Generally, pro forma adjustments should be presented gross on the face of the pro forma statements. Alternatively, components of the adjustments could be broken out in a sufficiently detailed manner in the notes to the pro forma statements.

The column of pro forma adjustments should include references to the explanatory notes that clearly summarize each pro forma adjustment and the assumptions involved in calculating it. For example, footnotes to the pro forma financial information depicting the effects of a purchase business combination should disclose the expected useful lives or amortization periods of significant assets acquired, including identified intangibles.

In addition, certain events or charges for which a pro forma adjustment is not appropriate may require disclosure in notes to the pro forma financial information. For example:

- The effect of any unusual events on the results of operations for the most recent fiscal year should be disclosed in a note to the pro forma income statement.[7] In addition, see Section 5.3.2 for considerations about presenting an additional pro forma income statement for the most recent 12-month period when there are unusual events.

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[7] Although not specified in the rules, in practice this requirement also is applicable to any interim pro forma condensed income statements required.

- The notes to the pro forma financial information should address any material nonrecurring charges or credits and related tax effects that result directly from the transaction and will be included in the registrant's income statement after the transaction. The disclosure should clearly indicate that such charges or credits were not included in the pro forma condensed income statement.

Illustration 4-4: Explanatory notes example

Notes to Unaudited Pro Forma Condensed Combined Financial Information
(in thousands, except per share information)

Note 1 — Basis of presentation

The unaudited pro forma condensed combined financial statements are based on Registrant's and ABC Company's historical consolidated financial statements as adjusted to give effect to the acquisition of ABC Company and the debt issuance necessary to finance the acquisition. The unaudited pro forma combined statements of operations for the six months ended 30 June 20X4 and the 12 months ended 31 December 20X3 give effect to the ABC Company acquisition as if it had occurred on 1 January 20X3. The unaudited pro forma combined balance sheet as of 30 June 20X4 gives effect to the ABC Company acquisition as if it had occurred on 30 June 20X4.

Note 2 — Preliminary purchase price allocation

On 20 August 20X4, Registrant acquired ABC Company for total consideration of approximately $37.8 million. The Company financed the acquisition through the issuance of an additional term loan. The unaudited pro forma condensed combined financial information includes various assumptions, including those related to the preliminary purchase price allocation of the assets acquired and liabilities assumed of ABC Company based on management's best estimates of fair value. The final purchase price allocation may vary based on final appraisals, valuations and analyses of the fair value of the acquired assets and assumed liabilities. Accordingly, the pro forma adjustments are preliminary and have been made solely for illustrative purposes.

The following table shows the preliminary allocation of the purchase price for ABC Company to the acquired identifiable assets, liabilities assumed and pro forma goodwill:

Total purchase price	$ 37,800
Cash and cash equivalents	1,400
Accounts receivable, net	13,200
Other current assets	1,100
Property and equipment, net	13,400
Intangible assets, net	15,100
Total identifiable assets	44,200
Accounts payable	(19,100)
Accrued liabilities and other current liabilities	(1,500)
Total liabilities assumed	(20,600)
Total pro forma goodwill	$ 14,200

[Include additional disclosure here or under "Pro forma adjustments" regarding the assumptions and methodologies for significant acquired assets and liabilities. For example, describe the nature of the acquired intangible assets, including the methodologies used to determine the preliminary valuation of each material category and the estimated useful lives. If the allocation is preliminary, uncertainties regarding the effects of amortization periods assigned to the assets should be highlighted.]

Note 3 — Pro forma adjustments

The pro forma adjustments are based on our preliminary estimates and assumptions that are subject to change. The following adjustments have been reflected in the unaudited pro forma condensed combined financial information:

Adjustments to the pro forma condensed combined balance sheet

(a) Reflects the preliminary fair value adjustment of $2.1 million to the acquired property and equipment *[Describe or cross-reference to disclosure about the methodologies, assumptions and estimated useful lives]*

(b) Reflects the fair value adjustment of $6.2 million for intangible assets *[Describe or cross-reference to disclosure about the methodologies, assumptions and estimated useful lives]*

(c) Reflects the term loan issuance of $37.8 million necessary to finance the acquisition

(d) Reflects the preliminary estimate of goodwill, which represents the excess of the purchase price over the fair value of ABC Company's identifiable assets acquired and liabilities assumed as shown in Note 2

Adjustments to the pro forma condensed statements of operations

(e) Reflects the estimated depreciation and amortization expense related to the acquired property and equipment and intangible assets discussed at Notes 3(a) and 3(b), respectively

(f) Reflects the additional interest expense related to the term loan issuance of $37.8 million with a fixed 4.5% interest rate

(g) Reflects the income tax effect of pro forma adjustments based on the estimated combined statutory tax rate of 35%

[Include additional footnote disclosures for each referenced adjustment in the pro forma financial information as necessary to describe or cross-reference to a discussion of the nature and significant assumptions related to the adjustment. Refer to Section 6, Pro forma adjustments, for additional illustrations and discussion of common pro forma adjustments.]

4.2 Specific or unique circumstances

4.2.1 Pro forma financial information involving multiple transactions

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro Forma Financial Information

Rule 11-02(b), Preparation Requirements, Form and content, Instructions

6. When consummation of more than one transaction has occurred or is probable during a fiscal year, the pro forma financial information may be presented on a combined basis; however, in some circumstances (e.g., depending upon the combination of probable and consummated transactions, and the nature of the filing) it may be more useful to present the pro forma financial information on a disaggregated basis even though some or all of the transactions would not meet the tests of significance individually. For combined presentations, a note should explain the various transactions and disclose the maximum variances in the pro forma financial information which would occur for any of the possible combinations. If the pro forma financial information is presented in a proxy or information statement for purposes of obtaining shareholder approval of one of the transactions, the effects of that transaction must be clearly set forth.

In some cases, more than one transaction will have occurred during a fiscal year or will be probable. These transactions generally may be combined when presenting pro forma financial information, with footnote explanation of the various transactions. However, it may be more useful to present the information on a disaggregated basis (i.e., presenting some or all of the transactions separately). A format with separate columns for each transaction with subtotals that are meaningful would be a logical way to present the various transactions separately.

Furthermore, the SEC staff requires registrants to present pro forma financial information for a particular acquisition or transaction on a disaggregated basis (that is, separately from unrelated transactions for which pro forma information may be required) in the following circumstances:[8]

- The pro forma financial information is presented in a proxy or information statement to obtain shareholder approval for the particular acquisition or transaction.
- A Form 8-K containing pro forma financial information is required to be filed for the particular transaction (e.g., the acquisition is significant under Rule 3-05 of Regulation S-X).
- The pro forma financial information reflects proceeds of an offering that will be used to fund the particular acquisition.

In some circumstances, a registrant may be required to present pro forma financial information for both a previous transaction and a proposed transaction. For example, in connection with a merger proxy statement or registration statement on Form S-4, pro forma financial information may be required for previous transactions in addition to the pro forma information required for the proposed transaction subject to the merger proxy or registration statement. In that event, the pro forma information should be presented together, but the presentation should clearly distinguish between the proposed transaction subject to the merger proxy or registration statement and other transactions.

If pro forma information with respect to previous transactions is incorporated by reference in the merger proxy or registration statement (e.g., from a previously filed Form 8-K), the registrant may carry forward the previously filed pro forma results as the starting point when presenting the pro forma financial information for the proposed transaction. See Item 5 of Form S-4 and Item 14(b)(11) of Schedule 14A.

In these cases, along with appropriate labeling of the pro forma columns, it's important that the introductory paragraph provide sufficient disclosure about the nature of the multiple transactions reflected and where those transactions are reflected in the pro forma financial information.

[8] SEC staff's Financial Reporting Manual Section 3240.6.

Illustration 4-5: Multiple transactions, with one requiring shareholder approval

On 1 May 20X4, Registrant presents pro forma financial information as of and for the year ended 31 December 20X3 in a proxy statement to obtain shareholder approval for the acquisition of Acquiree A.

The pro forma financial information also reflects an unrelated transaction for the completed acquisition of Acquiree B that required separate financial statements under Rule 3-05 of Regulation S-X and was previously reported on Form 8-K in 20X4.

The pro forma financial information should be presented on a disaggregated basis because shareholders are asked to vote on the proposed acquisition of Acquiree A.

Combined pro forma presentation

- The following shows an example of the separate columns that could be presented in one set of pro forma financial information that disaggregates the individual transactions:

Unaudited Pro Forma Condensed Combined Balance Sheet [Statement of Operations]

Registrant historical financial statements	Acquiree B historical financial statements	Pro forma adjustments (acquisition of Acquiree B)	Pro forma results (adjusted for acquisition of Acquiree B)	Acquiree A historical financial statements	Pro forma adjustments (acquisition of Acquiree A)	Pro forma results (combined)

Pro forma financial information incorporating pro forma results from the Form 8-K

- Conversely, Registrant may incorporate by reference pro forma financial information from the Form 8-K. In this case, the pro forma financial information presented for the proposed acquisition of Acquiree A would carry forward the Registrant's pro forma results adjusted for the acquisition of Acquiree B as shown:

Unaudited Pro Forma Condensed Combined Balance Sheet [Statement of Operations]

Registrant pro forma financial statements (adjusted for acquisition of Acquiree B)	Acquiree A historical financial statements	Pro forma adjustments (acquisition of Acquiree A)	Pro forma results (combined)

4.2.2 Transactions with range of possible results

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro Forma Financial Information

Rule 11-02(b), Preparation Requirements, Form and content

(8) If the transaction is structured in such a manner that significantly different results may occur, additional pro forma presentations shall be made which give effect to the range of possible results.

A registrant may need more than one pro forma presentation if a proposed transaction may have significantly different results. The additional results may be equally important, depending on the facts and circumstances.

For example, more than one pro forma presentation may be necessary to reflect varying assumptions about the number of securities sold in a minimum/maximum transaction (e.g., the transaction will not close unless a minimum number of securities is sold), the ultimate ownership percentage in a proposed acquisition or to reflect variability in the purchase price for a proposed acquisition. Additional pro forma financial information may include:

- Additional pro forma balance sheet if the minimum or maximum outcome only affects the balance sheet.
- Footnote-only disclosure about the outcomes and effects in the pro forma financial information if the minimum or maximum outcome does not have a pervasive effect on the financial statements.
- Multiple sets of full pro forma financial information, particularly if the varying outcomes would affect the accounting method applied.

Illustration 4-6: Multiple pro forma presentations

A registrant is conducting a tender offer for any or all of the common stock of a target company in exchange for its common stock. The registrant determines that the possible outcomes include the acquisition of anywhere from 20% to 100% of the common stock of the target company. Since the maximum number of shares acquired in the tender offer would result in consolidation by the registrant, while the minimum number of shares acquired would result in the registrant applying the equity method of accounting, the registrant would present separate pro forma financial statements to depict the minimum and maximum outcomes.

- The following shows an example of the separate columns that could be used to present the minimum and maximum outcomes:

Unaudited Pro Forma Condensed Combined Balance Sheet [Statement of Operations]

	Assuming 100% of shares acquired			Assuming 20% of shares acquired	
Registrant historical financial statements	Company A historical financial statements	Pro forma adjustments (acquisition of Company A)	Pro forma results (combined)	Pro forma adjustments (equity method investment in Company A)	Pro forma results (combined)

If there is only one variable that may produce different outcomes that do not have a pervasive effect on the pro forma financial information, a sensitivity analysis for a change in the variable may be disclosed in the notes of the pro forma financial information instead of presenting multiple sets of pro forma financial statements.

Illustration 4-7: Sensitivity analysis

ABC, Inc., an SEC registrant, has entered into an agreement to acquire XYZ Corp. in exchange for two million common shares. ABC, Inc. is filing a proxy statement/prospectus on Form S-4 to solicit shareholder approval and register the shares to exchange in the acquisition. The purchase price and resulting goodwill will vary based on the market price of ABC, Inc.'s common shares upon consummation of the acquisition. ABC, Inc. believes that a 10% fluctuation in the market price of its common stock is reasonably possible based on its average volatility.

In preparing the pro forma financial information included in the Form S-4, ABC, Inc. estimates the expected purchase price based on its closing market price on the filing date. In addition, ABC, Inc. should disclose the sensitivity of the purchase price and goodwill to changes (e.g., 10%) in the price of ABC, Inc.'s common stock. For example, ABC, Inc. could include the following chart to summarize the changes in the notes to the unaudited pro forma financial information:

(unaudited, in thousands)	Purchase Price	Estimated Goodwill
As presented in the pro forma combined results	$ 40,000	$ 14,200
10% increase in common stock price	44,000	18,200
10% decrease in common stock price	36,000	10,200

4.3 Pro forma financial information presented on the face of the historical financial statements

In certain circumstances, the presentation of a pro forma balance sheet or pro forma EPS is required in a registration statement in connection with an IPO. For example, SAB Topic 1.B.3 requires the presentation of pro forma EPS on the face of the historical financial statements included in an IPO registration statement when the offering proceeds are used to pay dividends in excess of current-year earnings at or prior to closing of the IPO.

Refer to Section 7.1, *IPO considerations*, for further discussion of the circumstances and illustrations when presenting a pro forma balance sheet or pro forma EPS on the face of the historical financial statements.

5 Periods to be presented

5.1 Overview

This section describes the periods to be presented in the pro forma balance sheet and income statement and discusses how to update pro forma information in registration statements.

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro forma financial information

Rule 11-02(c), Preparation requirements, Periods to be presented

(1) A pro forma condensed balance sheet as of the end of the most recent period for which a consolidated balance sheet of the registrant is required by S-X Rule 3-01 shall be filed unless the transaction is already reflected in such balance sheet.

(2) (i) Pro forma condensed statements of income shall be filed for only the most recent fiscal year and for the period from the most recent fiscal year end to the most recent interim date for which a balance sheet is required. A pro forma condensed statement of income may be filed for the corresponding interim period of the preceding fiscal year. A pro forma condensed statement of income shall not be filed when the historical income statement reflects the transaction for the entire period.

(ii) For a business combination accounted for as a pooling of interests, the pro forma income statements (which are in effect a restatement of the historical income statements as if the combination had been consummated) shall be filed for all periods for which historical income statements of the registrant are required.

(3) Pro forma condensed statements of income shall be presented using the registrant's fiscal year end. If the most recent fiscal year end of any other entity involved in the transaction differs from the registrant's most recent fiscal year end by more than 93 days, the other entity's income statement shall be brought up to within 93 days of the registrant's most recent fiscal year end, if practicable. This updating could be accomplished by adding subsequent interim period results to the most recent fiscal year-end information and deducting the comparable preceding year interim period results. Disclosure shall be made of the periods combined and of the sales or revenues and income for any periods which were excluded from or included more than once in the condensed pro forma income statements (e.g., an interim period that is included both as part of the fiscal year and the subsequent interim period). For investment companies subject to S-X Rules 6-01 to 6-10, the periods covered by the pro forma statements must be the same.

(4) Whenever unusual events enter into the determination of the results shown for the most recently completed fiscal year, the effect of such unusual events should be disclosed and consideration should be given to presenting a pro forma condensed income statement for the most recent twelve-month period in addition to those required in paragraph (c)(2)(i) above if the most recent twelve-month period is more representative of normal operations.

5.2 Pro forma condensed balance sheet

When pro forma financial information is required, a pro forma condensed balance sheet must be presented as of the same date as the latest balance sheet filed or required to be filed by S-X Rule 3-01. That would be the registrant's most recent fiscal year end or the end of the subsequent interim period if the registrant's interim financial statements are required. However, if the transaction is already reflected in the latest balance sheet in the filing, a pro forma balance sheet is not required. For example, a pro forma balance sheet for a significant acquisition that closed on 1 March is not required when a registration statement for a calendar year-end registrant is filed after the registrant files its first-quarter Form 10-Q.

The date of the pro forma condensed balance sheet should align with the date of the registrant's most recent financial statements included in the filing. If financial statements for the registrant's most recently completed annual or interim period are not yet required or included in the filing, the pro forma financial information would be as of the most recent balance sheet included in the filing.

For example, assume that a calendar year-end registrant that is an accelerated filer files a registration statement on 1 May that includes financial statements and pro forma financial information for an acquisition that closed during the first quarter. The registration statement incorporates the registrant's Form 10-K for its most recently completed annual period but does not include first-quarter financial statements because the registration statement is filed within 129 days from year end. The registration statement would include a condensed pro forma balance sheet as of the registrant's most recent year end.

5.3 Pro forma condensed income statement

Pro forma condensed income statements are required for the registrant's most recent fiscal year and subsequent year-to-date interim period required or included in the filing. A pro forma income statement for the corresponding interim period of the preceding fiscal year is optional. With the exception of certain situations discussed in Section 5.3.1, pro forma income statement is generally not presented for more than one full year.

The pro forma income statements should be prepared as if the transaction occurred at the beginning of the full fiscal year presented. If the transaction has been reflected in the consolidated income statement included in the filing for an entire fiscal year, a pro forma income statement should not be presented.

5.3.1 Pro forma income statement required for all periods presented

The SEC staff generally does not permit a registrant to present more than one full year of pro forma results of operations. However, pro forma condensed income statements are required for all historical financial statement periods presented in a registrant's filing when the pro forma financial information gives effect to the following transactions:

- Reorganization of entities under common control (ASC 805, *Business Combinations*, paragraphs D14-D18)
- Discontinued operations (ASC 205, *Presentation of Financial Statements*) not yet reflected in the historical financial statements

Common control transactions include a transfer of net assets or an exchange of equity interests between entities under common control. An example would be the contribution of a business by a parent company to its consolidated subsidiary that reports separately as a registrant. In that circumstance, the subsidiary would account for the receipt of the business as a common control transaction. In some circumstances, a transaction that will be accounted for as a reorganization of entities under common control may occur after the date of the registrant's latest balance sheet included in the proxy or registration statement. When post-transaction financial statements reflecting the reorganization have not been issued, pro forma income statements are required for all years and any subsequent interim period, as applicable.

Refer to Section 6.2.3 for additional considerations related to pro forma adjustments and retrospectively revising EPS for all periods when there is a reorganization of entities under common control.

Under US GAAP, a disposal transaction qualifies for reporting as a discontinued operation if all of the following criteria are met:

- The disposal group is a component of an entity (or group of components)
- The component of an entity (or group of components) meets the held for sale criteria, is disposed of by sale, or is disposed of other than by sale
- The component of an entity (or group of components) represents a strategic shift that has (or will have) a major effect on the entity's operations and financial results

A newly acquired business that is classified as held for sale on acquisition also qualifies for reporting as a discontinued operation.

When post-transaction financial statements reflecting the discontinued operations have not been issued, pro forma income statements are required for all years and any subsequent interim period, as applicable.

5.3.1.2 Pro forma information reflects other transactions

If pro forma financial information gives effect to other transactions (e.g., a new contractual arrangement, a reduction in interest expense due to repayment of debt) in addition to discontinued operations or a reorganization of entities under common control, the pro forma presentations for the other transactions should be limited to the most recent year and interim period. Disclosures should clearly describe how transactions are reflected in the periods presented.

For example, a registrant may be required to provide pro forma financial information in a Form 8-K, merger proxy or registration statement to reflect a recently completed or probable business combination. In some circumstances, a registrant may also need to give pro forma effect to discontinued operations for a disposal that occurred during the most recent interim period that did not trigger a separate pro forma reporting requirement (i.e., less than 10% significant) and for which the historical annual financial statements have not yet been retrospectively revised.

The SEC staff believes that in such a situation, the periods for which pro forma adjustments are presented generally should be based on the transaction that is triggering the pro forma reporting requirements (i.e., the business combination). Therefore, the pro forma adjustments for the discontinued operations would be limited to only the most recent year and interim period. Nonetheless, while the separate pro forma reporting requirement may not have been triggered based on the significance of the disposal, the SEC staff has said that if the registrant determines the discontinued operation to be material to investors, pro forma income statements for the discontinued operation may be necessary for each fiscal year and any subsequent year-to-date interim period for which the registrant's historical financial statements are provided.

5.3.2 Historical results include unusual events

In accordance with S-X 11-02(c)(4), registrants should disclose unusual events that affect the operating results presented for the most recently completed fiscal year. In addition, the registrant should consider presenting an additional pro forma income statement for the most recent 12-month period (e.g., trailing 12 months) if it is more representative of normal operations. However, the effects of the unusual events should not be eliminated from the pro forma presentation. In certain circumstances, registrants may determine that it is more appropriate to present a financial forecast in lieu of a pro forma income statement. For further discussion, refer to Section 7.2, *Financial forecasts*.

5.4 Combining entities with different fiscal years

The pro forma income statement must be presented based on the fiscal year of the registrant. The following special rules apply when another entity involved in the transaction has a fiscal year end that differs from that of the registrant:

- If the other entity's year end differs by 93 days or less from the registrant's year end, the registrant would combine its income statements and that of the other entity using their respective fiscal years.
- If the other entity's year end differs by more than 93 days, the registrant would update the annual income statement of the other entity to a period ending within 93 days of the registrant's year end. This is accomplished by adding subsequent interim period results to the latest fiscal year-end information and subtracting interim-period financial information of the comparable period in the preceding year.

The periods that are being combined for both the fiscal-year and interim-period pro forma income statements must be disclosed. Sales, revenue and income for any periods excluded from or included more than once in the pro forma income statements because of different year ends also must be disclosed. For example, an interim period may be included as part of the latest fiscal year in the pro forma presentation and also included in the latest interim-period presented.

For registered investment companies, the periods covered by the pro forma statements must be the same.

5.5 Changes in fiscal year end

Rules 13a-10 and 15d-10 of the Exchange Act provide the SEC's reporting and filing requirements when a registrant changes its fiscal year end or a successor issuer has a different fiscal year end than its predecessor. These rules designate as the "transition period" the short period between the end of the registrant's most recent fiscal year and the opening date of its newly selected fiscal year (e.g., a change in fiscal year from 31 December to 30 September would result in a nine-month transition period). Similarly, the reports required by Rules 13a-10 and 15d-10 are designated "transition reports." Our publication, *SEC annual reports — Form 10-K*, includes more information on transition reports covering the transition period.

Pursuant to S-X Rule 3-06, a transition period of nine months or more is considered a full year. If a pro forma condensed income statement is required in the year after a registrant has changed its fiscal year end and has filed a transition report on Form 10-K for a period of nine months or more, the registrant can satisfy that requirement by providing a pro forma condensed income statement for the transition period (which approximates one year pursuant to S-X Rule 3-06).

When the transition period is less than nine months, a pro forma condensed income statement that satisfies the requirement for one year may include either:

- A pro forma income statement for a nine- to 12-month period ending on the registrant's new fiscal year end using a combination of the transition period, supplemented as necessary by earlier periods to satisfy the nine- to 12-month requirement in S-X Rule 3-06 (accompanied by the year-to-date interim period subsequent to the transition period)
- A pro forma income statement for the registrant's previous full fiscal year, along with pro forma income statement(s) for the subsequent transition period and any year-to-date interim period subsequent to the transition period

The periods of the registrant and the acquiree are subject to the 93 day rule (i.e., the acquiree's period end should be within 93 days of the registrant's period end). In addition, the length of the income statement period of an acquiree should be consistent with that of the acquirer (i.e., the length of the period presented for the registrant and acquiree should match). The respective periods being combined should be disclosed.

Illustration 5-1: Change in fiscal year end

A registrant changed its fiscal year from 30 April 20X2 to 31 December 20X2 and filed a transition report on Form 10-K for the eight-month period ended 31 December 20X2. The registrant acquired Buymee Corporation on 31 July 20X3. Buymee is a calendar-year company and is significant to the registrant under S-X Rule 3-05 at the 20% level. The registrant is required to file an Item 2.01 Form 8-K to include the financial statements of Buymee and pro forma financial information of the combined entity. What periods of the registrant and Buymee may be included in the pro forma presentation?

Option 1:

	Registrant (12 months)	Buymee (12 months)
"Most recent fiscal year" pro forma financial information	5/1/20X2 to 12/31/20X2 (i.e., transition period) plus 1/1/20X2 to 4/30/20X2	1/1/20X2 to 12/31/20X2

Because the transition period is only eight months, under this option, the period from 1 January to 30 April 20X2 is added to the transition period to comply with S-X Rule 3-06. Furthermore, the length of the period in the pro forma presentation for the registrant and Buymee should match (i.e., 12 months for the registrant and Buymee) and the periods should end within 93 days.

Option 2:

	Registrant	Buymee
Transition period (eight months)	5/1/20X2 to 12/31/20X2	5/1/20X2 to 12/31/20X2
Preceding 12-month period (old fiscal year)	5/1/20X1 to 4/30/20X2 (i.e., registrant's previous fiscal year)	5/1/20X1 to 12/31/20X1 plus 1/1/20X2 to 4/30/20X2

Note: Under both options, the 12-month periods of Buymee (i.e., the acquiree) are provided for illustration purposes only. The pro forma rules allow for the ends of the periods of the registrant and the acquiree to differ by up to 93 days. Therefore, while the length of the period in the pro forma presentation for the registrant and the acquiree should match, the periods of the acquiree could differ by up to 93 days.

For example, under option #2 the 12-month period of Buymee could be the 12-month period ended 31 March 20X2 (i.e., the end of the acquiree's first fiscal quarter) in which case the period end dates would be within 93 days, but Buymee's results for April 20X2 would be omitted from the pro forma presentation. As another alternative, the 12-month period of Buymee could be the 12-month period ended 30 June 20X2, in which case the period end dates would be within 93 days, but Buymee's results for May and June 20X2 would be included in the pro forma income statements for both the transition period and the preceding 12-month period.

5.6 Proxy and registration statements

Pro forma financial statements should generally include only the latest fiscal year and interim period. As discussed in Section 3, pro forma financial information must be provided in registration statements and certain merger proxy statements when a significant transaction or event has occurred or is probable, and the income statement for the most recent fiscal year does not reflect the transaction for the entire period. The age of the pro forma financial information included in a registration statement is based on the age of the registrant's financial statements required by S-X Rule 3-12 (or S-X 8-08 for smaller reporting companies). For registration statements, a foreign private issuer would follow the financial statement age requirements in Item 8 of Form 20-F.

5.6.1 Updating pro forma information

The financial statements and pro forma financial information must comply with the age requirements at the date the registration statement is filed as well as when it becomes effective. When amending an existing registration statement (i.e., post-effective amendment) or filing a new registration statement, a registrant may need to update previously filed pro forma information.

Illustration 5-2: Updating pro forma information in a registration statement

Company A acquires Forsale Corporation, a calendar-year company, on 1 June 20X1. Based on the level of significance of Forsale to Company A under S-X Rule 3-05, Company A files a Form 8-K that includes the financial statements of Forsale for the year ended 31 December 20X0 and the interim period ended 31 March 20X1. Company A also includes pro forma information reflecting the acquisition through 31 March 20X1 in the Form 8-K.

Company A plans to file a new registration statement that is expected to be declared effective on 1 December 20X1. Company A's Form 10-Q as of 30 September 20X1 is incorporated by reference into the new registration statement. Company A must update the pro forma financial information in the new registration statement through 30 September 20X1.

Under S-X Rule 3-05, there is no requirement to update the financial statements of Forsale since its latest interim financial statements prior to the acquisition (i.e., 31 March 20X1) have already been filed and will be incorporated by reference into the registration statement. However, the pro forma financial information previously filed in the same Form 8-K would need to be updated through 30 September 20X1 to correspond with the registrant's latest interim period that is incorporated by reference in the registration statement. As a result, the pre-acquisition historical results of Forsale included in the pro forma financial information would be updated through 1 June 20X1 (i.e., the date of the acquisition).

5.7 Cross-border business combinations

As previously discussed, the age of pro forma financial information is based on the age of financial statements the registrant is required to file. Therefore, an FPI that acquires a US target would determine the age of the pro forma financial information based on the financial statement age requirements in Item 8 of Form 20-F. Conversely, a US registrant that acquires a foreign target would determine the age of the pro forma financial information based on the latest financial statements the registrant is required to file.

When a US registrant provides financial statements of an acquired or to be acquired FPI or a foreign acquiree that meets the definition of a foreign business under S-X Rule 1-02(l), the age of financial statements required under S-X Rule 3-05 are different from those required for a US target. For example, if the acquired company is an FPI or foreign business, a registrant may only need to include unaudited interim financial statements of the target for a period covering the first six months of the year in a Form 8-K or a registration statement. [9] For a US target, a more current period may be required.

Therefore, in cross-border transactions, the pro forma financial information that a US registrant (acquirer) will be required to provide may be as of a date that is more current than the S-X Rule 3-05 financial statements required for a foreign target. For example, assume that on 15 June 20X1, a US registrant acquires a foreign business that is significant at the 25% level under S-X Rule 3-05 and appropriately files the audited financial statements of the calendar year-end foreign target as of 31 December 20X0 in an Item 9.01 Form 8-K. The Form 8-K also includes pro forma financial information for the year ended 31 December 20X0 and for the three months ended 31 March 20X1. Since the pro forma periods presented are based on the most recent financial statements of the US registrant, the periods presented will be as of a date that is more current than the S-X Rule 3-05 financial statements of the foreign business. In this example, the three-month period of the foreign business combined with acquirer's first quarter results could be those of either the three months ended 31 March 20X1, or 31 December 20X0, under the 93-day rule.

Likewise, when an FPI acquires a US domestic target company, the S-X Rule 3-05 financial statements of the domestic target company may be required for periods that are more current than the financial statements of the FPI. In these circumstances, the age of the pro forma financial information would still be based on the FPI's latest financial statements included in the filing.

As discussed in Section 5.4, the pro forma rules allow for the fiscal year end of the registrant and the target to be different by up to 93 days. If the target's year end differs by more than 93 days, the pro forma information will need to be updated to a period ending within 93 days of the registrant's year end. The staff will consider combinations of the target's periods that overlap or include gaps of up to 93 days. However, the annual and interim periods of the target should be of the same length required for the registrant and there should be no overlap or gap in the registrant's periods included in the pro forma information.

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[9] Consideration also should be given to other conditions in Item 8.A.5 of Form 20-F when determining the requirement to include interim financial statements. For example, local stock exchanges may require a company to publish interim financial information that covers a more current period than the information required by SEC rules. If that's the case, the registrant must include the more current financial information in the filing with the SEC.

6 Pro forma adjustments

Pro forma adjustments to historical results and related disclosures give investors an idea of what a registrant's financial results might have looked like if a transaction or other event had occurred at an earlier time.

However, the application of the criteria in Article 11 of Regulation S-X describing what constitutes an appropriate pro forma adjustment may not always be clear. The SEC staff, in fact, frequently comments on pro forma adjustments. The staff in the SEC's Division of Corporation Finance also has included some interpretive guidance for certain adjustments in its Financial Reporting Manual. The extent and quantity of pro forma adjustments will depend on the facts and circumstances of the transaction(s) or event(s) reflected in the pro forma financial statements.

However, it's important that registrants consider the relevant criteria to support each adjustment. Registrants also need to focus on making clear and transparent disclosures about pro forma adjustments.

6.1 Criteria for making pro forma adjustments

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro forma financial information

Rule 11-02(b), Preparation requirements, Form and content

(6) Pro forma adjustments related to the pro forma condensed income statement shall be computed assuming the transaction was consummated at the beginning of the fiscal year presented and shall include adjustments which give effect to events that are

(i) directly attributable to the transaction,

(ii) expected to have a continuing impact on the registrant, and

(iii) factually supportable.

Pro forma adjustments related to the pro forma condensed balance sheet shall be computed assuming the transaction was consummated at the end of the most recent period for which a balance sheet is required by Item 3-01 of Regulation S-X and shall include adjustments which give effect to events that are directly attributable to the transaction and factually supportable regardless of whether they have a continuing impact or are nonrecurring. All adjustments should be referenced to notes which clearly explain the assumptions involved.

6.1.1 Directly attributable

Pro forma adjustments must be directly attributable to the transaction or event that's being reflected in the pro forma financial statements. For example, when pro forma financial statements reflect a business combination, adjustments to reflect the purchase price allocation are directly attributable to the business combination. To apply the directly attributable criterion, registrants should consider whether the adjustment results solely from the transaction for which pro forma financial information is being presented. In other words, it is helpful to consider whether the adjustment could occur if the transaction hadn't occurred and vice versa. For example, any increase in costs related to being a public company would be incurred subsequent to and would be incidental to the offering of shares in an IPO (rather than directly attributable to the IPO) and therefore would not be presented as pro forma adjustments in the pro forma financial statements in the IPO registration statement.

6.1.2 Continuing impact on the registrant

As explained in Rule 11-02 of Regulation S-X, pro forma information should show the continuing impact that a transaction has on the registrant. Accordingly, adjustments in the pro forma income statement should reflect the continuing impact of a transaction, which generally means it will affect the results of operations for a period greater than 12 months. Items with a nonrecurring effect on the combined entity should not be presented as pro forma adjustments in the pro forma income statement. Instead, they must be separately disclosed in a way that clearly indicates the nonrecurring effect. However, adjustments to the pro forma balance sheet do not need to reflect items with a continuing impact, so they should include nonrecurring pro forma adjustments. Article 11[10] describes nonrecurring items as those that result directly from the transaction and that will be included in the income of the registrant for the 12 months after the transaction.

Income statement items not reflected in the historical financial statements that are directly attributable to the transaction and factually supportable but nonrecurring in nature (e.g., transaction costs) normally should not be reflected in the pro forma income statement as pro forma adjustments to income but should be reflected in the pro forma balance sheet as adjustments to retained earnings.

In addition, it is not appropriate to remove the effects of material nonrecurring items included in a historical income statement from which the pro forma income statement is derived unless these items are directly related to the transaction. For example, if the historical income statement included a material restructuring provision (which did not result directly from the transaction), it is not appropriate to eliminate the effects of the provision by using a pro forma adjustment. Such an adjustment would not be directly attributable to the transaction. In this situation, companies may want to provide disclosure about unusual and/or infrequent transactions and events reflected in the pro forma financial statements similar to what they disclosed in the related historical financial statements.

6.1.3 Factually supportable

The SEC staff believes that for a pro forma adjustment to be considered factually supportable, there should be reliable, documented evidence exists.[11] Such evidence may include an executed contract, letter of intent or completed transaction. Evidence that is based on management's plans, intent or projections generally is not factually supportable.

A registrant that is reflecting a probable transaction in pro forma financial statements in a registration statement may not have an agreement or other underlying evidence to factually support an adjustment at the time of filing. However, adjustments may be made, along with transparent disclosures about the related uncertainties, if evidence will be available by the effective date of the registration statement (e.g., an agreement must be in place for the transaction to be consummated). For example, the terms of debt financing necessary to complete an acquisition may not be final as of the filing date of a pre-effective amendment. It would nevertheless be appropriate to include pro forma adjustments to reflect the debt in the balance sheet (i.e., financing is necessary for the transaction to be consummated), along with robust disclosures in the pro forma income statement about the related interest expense.

Certain events or management plans may be too uncertain to meet the factually supportable criterion. For example, costs associated with restructuring activities and their related effects (e.g., cost savings and synergies) may not be appropriate adjustments. See further discussion in Section 6.2.1.16.

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[10] Rule 11-02(b)(5) of Regulation S-X.

[11] SEC staff's Financial Reporting Manual Section 3280.

6.2 Pro forma adjustment illustrations

The sections below discuss and provide examples of situations when pro forma adjustments typically are made.

6.2.1 Business combinations

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro forma financial information

Instruction 2 to Rule 11-02(b), Preparation requirements, Form and content

For a business combination, pro forma adjustments for the income statement shall include amortization, depreciation and other adjustments based on the allocated purchase price of net assets acquired.

In some transactions, such as in financial institution acquisitions, the purchase adjustments may include significant discounts of the historical cost of the acquired assets to their fair value at the acquisition date. When such adjustments will result in a significant effect on earnings (losses) in periods immediately subsequent to the acquisition which will be progressively eliminated over a relatively short period, the effect of the purchase adjustments on reported results of operations for each of the next five years should be disclosed in a note.

Business combinations accounted for as purchases under ASC 805 result in the assets acquired and liabilities assumed generally being adjusted to their fair values. Therefore, when pro forma financial statements give effect to a business combination, the pro forma adjustments should reflect:

- The company's plans for allocating the consideration transferred (i.e., the purchase price), including adjusting assets and liabilities to fair value and recognizing intangibles, including goodwill
- The effects of additional financing necessary to complete the acquisition

The sections below illustrate common pro forma adjustments and disclosures that may be required in pro forma financial statements that give effect to a business combination.

6.2.1.1 Calculation of purchase price

Pro forma financial statements for a business combination should include a schedule that shows how the total purchase price was calculated, if this is not evident from other disclosures. This schedule should include calculations of any applicable noncash consideration (e.g., stock).

When calculating the value of stock to be issued in a transaction that is not yet completed (i.e., a probable transaction), registrants should use a stock price as of a date that is in reasonable proximity to the filing date. In addition, the notes to the pro forma balance sheet should disclose the date on which the stock price was determined and a sensitivity analysis for the range of possible outcomes based upon reasonably likely increases and decreases in that stock price.

The following example illustrates the disclosures for an estimated purchase price prior to completion of a transaction.

Illustration 6-1: Schedule and disclosures of estimated purchase price calculation

In this example, assume that pro forma financial statements are required in a registration statement that's filed on 17 August 20X5.

Notes to Unaudited Pro Forma Condensed Combined Financial Information

Note 2 Estimated Purchase Price Consideration

Estimated consideration of approximately $250.8 million is based on the Company's closing share price of $28.35 on 31 July 20X5. The value of purchase price consideration will change based on fluctuations in the share price of the Company's common stock and the number of common shares of Target XYZ outstanding on the closing date.

The following table summarizes the components of the estimated consideration (in thousands except per share information):

Estimated Target XYZ shares outstanding*		5,650
Cash consideration (per Target XYZ share)	$	11.50
Estimated cash portion of purchase price	$	64,975
Estimated Target XYZ shares outstanding*		5,650
Exchange ratio		1.16
Total Company common shares issued		6,554
Company's share price**	$	28.35
Equity portion of purchase price	$	185,806
Total estimated consideration to be paid	**$**	**250,781**

* Represents Target XYZ's outstanding shares as of 30 June 20X5.

** Represents the Company's share price as of 17 August 20X5.

The Company anticipates using approximately $5 million of cash on hand and approximately $60 million of debt financing to fund the cash portion of the purchase price.

Note: For purposes of this illustration, a table showing a sensitivity analysis for the range of possible outcomes based upon reasonably likely increases and decreases in the stock price is excluded. Refer to Section 4.2.2 for examples of sensitivity disclosures that may be appropriate when a purchase price is preliminary.

6.2.1.2 Contingent consideration

ASC 805 requires an acquirer to recognize the fair value of contingent consideration as of the acquisition date as part of the consideration transferred in exchange for an acquired business. If a portion of the purchase price is contingent on future events occurring or other conditions being met, the terms and the potential effect on future income (e.g., change in fair value of contingent consideration upon post-closing remeasurement of the contingent consideration) should be disclosed in the pro forma financial statements.

Contingent consideration that's classified as a liability in an acquirer's balance sheet is remeasured at fair value through net income at the end of each reporting period. If pro forma financial statements that were filed upon consummation of an acquisition must later be updated for a more recent period, no pro forma adjustments should be made in the pro forma income statement to reflect changes in the fair value of contingent consideration. Only changes in the fair value of contingent consideration recognized by an acquirer in post-acquisition periods would flow through to the updated pro forma income statements.

Illustration 6-2: Updating pro forma financial statements for contingent consideration

A registrant consummated a significant business combination on 24 August 20X5 and filed pro forma financial statements including a pro forma balance sheet as of 30 June 20X5 and income statements for the six-month period ended 30 June 20X5 and year ended 31 December 20X4 in an amended Form 8-K on 15 October 2015.

On 6 November 20X5, the acquirer filed its Form 10-Q for the period ended 30 September 20X5. On 20 November 20X5, the acquirer filed a new registration statement on Form S-3, which required updated pro forma financial statements for the year ended 20X4 and for the nine months ended 30 September 20X5. A pro forma balance sheet would not be required because the acquisition would be reflected in the 30 September 20X5 consolidated balance sheet that was filed in the 30 September 20X5 Form 10-Q and incorporated by reference in the Form S-3.

In the income statement for the nine months ended 30 September 20X5, the acquirer recognized an expense of $2.5 million, representing the change in the fair value of contingent consideration from the acquisition date through 30 September 20X5. This amount would be reflected in the historical acquirer column of the updated pro forma income statement for the nine months ended 30 September 20X5, but no additional pro forma adjustments would be made to the pro forma income statement or that of the fiscal year ended 20X4 with respect to the effects of contingent consideration.

6.2.1.3 Using preliminary purchase price allocation to reflect purchase accounting

Registrants often have to present pro forma financial information for a business combination before the purchase price allocation is finalized. When this happens, the pro forma financial statements should include transparent disclosures, similar to those required by ASC 805. These include:

- Disclosing that the purchase price allocation has not been finalized and explaining why
- Identifying the information that the registrant has arranged to obtain before the allocation can be finalized
- Furnishing other available information that will enable users of the pro forma financial statements to understand the magnitude of any potential change to the allocation (e.g., sensitivity analyses)
- Highlighting any other material uncertainties, and possible consequences of their resolution that affect the pro forma financial information

Similar disclosures should be made for contingent consideration, in addition to describing the nature of the underlying contingency(ies), if its fair value is not determinable at the date the pro forma financial information is filed. Refer to Section 6.2.1.2 above for further discussion about contingent consideration.

When the purchase price allocation reflected in the pro forma financial statements is preliminary, there is no obligation to update the pro forma financial statements at a future date when the purchase price allocation is finalized. However, if a registrant doesn't disclose the preliminary nature of the purchase price allocation, investors may reasonably assume that the purchase price is final and that all future revisions will be recognized in income.

The preliminary purchase price reflected in the pro forma financial statements should represent the best information available to management at the time of the filing, and the disclosures should discuss the potential changes in the purchase price allocation to provide transparency to investors.

The following example shows disclosures that may be appropriate to explain the preliminary nature of an acquirer's purchase price allocation. This same preliminary purchase price allocation will be used to illustrate other pro forma adjustments below.

Illustration 6-3: Disclosure of preliminary purchase price allocation

Notes to Unaudited Pro Forma Condensed Combined Financial Information

Note 2 Estimated consideration and preliminary purchase price allocation

The Company has performed a preliminary valuation analysis of the fair market value of ABC Company's assets to be acquired and liabilities to be assumed. Using the total consideration for the Acquisition, the Company has estimated the allocations to such assets and liabilities. The following table summarizes the allocation of the preliminary purchase price as of the transaction's closing date, 25 August 20X5 (in thousands):

Assets acquired*	$	59,118
Identifiable intangible assets		104,640
Goodwill		171,923
Liabilities assumed*		(83,008)
Total estimated consideration	**$**	**252,673**

* Individual assets and liabilities acquired have been condensed for purposes of this illustration.

This preliminary purchase price allocation has been used to prepare pro forma adjustments in the pro forma balance sheet and income statement. The final purchase price allocation will be determined when the Company has completed the detailed valuations and necessary calculations. The final allocation could differ materially from the preliminary allocation used in the pro forma adjustments. The final allocation may include (1) changes in fair values of property, plant and equipment, (2) changes in allocations to intangible assets such as trade names, technology and customer relationships as well as goodwill and (3) other changes to assets and liabilities.

6.2.1.4 Debt financing

Pro forma financial statements for a business combination should include adjustments to reflect the effects of additional financing necessary to complete the acquisition. Pro forma adjustments and disclosures related to such financing also should be considered, including:

- Interest expense associated with debt financing
- Debt issuance costs and related amortization
- Fair value adjustment of assumed debt and related amortization

In certain circumstances, the financing for an acquisition may not be known. In those situations, registrants should provide transparent disclosure and consider presenting a range of alternative outcomes as discussed in Section 4.2.2.

Debt adjustments will require companies to make certain assumptions about interest rates. For purposes of preparing the pro forma income statement, interest expense adjustments for fixed-rate debt generally should reflect the rate at the time a financing commitment was obtained or an estimated interest rate based on the index at the time of, or reasonably close to, the filing date. Registrants should not use the rate that could have been obtained at the beginning of the year when the transaction was assumed to have occurred.

For variable rate financing, the pro forma presentation generally should assume a current interest rate (e.g., based on the index at the time of, or reasonably close to, the filing date). However, in limited circumstances, such as where the acquired assets are variable rate instruments, the pro forma presentation should use debt financing rates based on the underlying interest rate index during the periods for which pro forma operating results are presented (e.g., interest expense on prime-plus-1% debt could be computed based on the prime rate in effect during the previous fiscal year and subsequent interim period). If financing is not at a fixed rate, the registrant should disclose the effect on pro forma income of a 1/8% change in interest rates.[12]

Obtaining new debt and refinancing acquiree debt to complete acquisition

An acquirer may obtain debt financing to pay for an acquisition and simultaneously refinance and extinguish existing debt owed by an acquiree. Potential pro forma adjustments are shown below.

Illustration 6-4: Pro forma adjustments — debt financing with acquiree debt extinguishment

When its acquisition of Target XYZ closes, the Company will incur approximately $72.5 million in 4.5% fixed-rate debt, less $2.5 million in debt issuance costs, a portion of which will be used to fund the acquisition for approximately $62.5 million. The Company also will extinguish Target XYZ's recently issued existing debt of approximately $7.3 million which includes a prepayment premium. In this case, the Company does not legally assume Target XYZ's outstanding debt.

The registrant might present the following pro forma financial information and disclosures related to the XYZ acquisition, assuming that changes in debt, debt issuance costs and interest expense are the only pro forma adjustments reflected in these line items (in thousands):

Unaudited Pro Forma Condensed Combined Financial Information

As of and for the six months ended 30 June 20X5

	Registrant Historical	Target XYZ (Acquiree)	Pro Forma Adjustments	Notes	Pro Forma Combined
Debt *	$ 51,104	$ 7,300	$ 62,700	(a)	$ 121,104
Interest expense	1,939	$ 188	1,568	(b)	3,695
For the year ended 31 December 20X4					
Interest expense	4,240	–	3,513	(b)	7,753

* Short- and long-term debt have been combined, and unamortized debt issuance costs have been netted against debt balances in this line item.

[12] SEC staff's Financial Reporting Manual Section 3260.

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) The net increase to debt (net of $2.5 million of debt issuance costs) reflects the new debt of $72.5 million incurred to finance the acquisition of Target XYZ, less the effects of extinguishing XYZ's outstanding debt for $7.3 million upon consummation of the acquisition.

Decrease for extinguishment of existing Acquiree debt	(7,300)
Increase for issuance of new debt	70,000
Pro forma adjustment to debt	**62,700**

(b) Represents the net increase to interest expense resulting from interest on the new debt to finance the acquisition of Target XYZ and extinguish its existing debt and the amortization of related debt issuance costs as follows:

	Six-months ended 30 June 20X5	Year ended 31 December 20X4
Elimination of interest expense and amortization of debt issuance costs — outstanding acquiree debt	(188)	-
Interest expense on new 4.5% debt	1,631	3,263
Amortization of new debt issuance costs	125	250
Pro forma adjustments	**1,568**	**3,513**

Analysis:

Because the changes to interest expense and amortization of debt issuance costs will affect periods beyond one year (i.e., will have a continuing impact), it is appropriate to reflect the effect of these items in the pro forma income statement.

Acquiree's debt assumed by the acquirer

If an acquirer assumes an acquiree's debt, the acquirer would measure the acquiree's debt at fair value as of the acquisition date and would amortize the remeasurement adjustment over the remaining life of the debt.

Pro forma adjustments should be made to the pro forma balance sheet to reflect the acquiree's debt at fair value and to eliminate any related unamortized debt issuance costs because such amounts would be eliminated upon fair value remeasurement. Because the fair value adjustment will be amortized over a period greater than one year (i.e., will have a continuing impact), it would be appropriate to reflect its effect on interest expense in the pro forma income statement.

Bridge loan financing

If long-term financing is not in place when an acquisition is consummated, an acquirer may use a short-term bridge loan to fund the cash consideration. Generally, such financing would be necessary to complete an acquisition and therefore would meet the directly attributable criterion. The bridge loan agreement would meet the factually supportable criterion. Therefore, bridge loan financing should be reflected in the pro forma balance sheet.

Given a bridge loan's short duration (e.g., 12 months or less), questions have arisen about whether the effects of bridge loans should be reflected in pro forma income statements (e.g., interest expense). These loans typically are replaced with permanent financing at or before the end of the term, and the short-term and permanent financing together will result in interest expense and amortization of debt issuance costs that will have a continuing impact on the registrant's operations (i.e., for longer than just 12 months). Therefore, we believe the income statement effects of bridge loan financing generally should be reflected in the pro forma income statement.

Illustration 6-5: Pro forma adjustments — bridge loan financing

The Company obtained bridge financing totaling $63 million just prior to the closing date of 24 August 20X5, of which $2.52 million comprises debt issuance costs. The interest on the short-term bridge loan will be based on one-month LIBOR, plus certain margins. This example assumes that ABC Corp. (acquiree) had no debt outstanding as of the acquisition date.

The Company might provide the following pro forma financial information and disclosures related to the ABC Corp. acquisition, assuming that changes in short-term debt, debt issuance costs and interest expense are the only pro forma adjustments reflected in these line items (in thousands):

Unaudited Pro Forma Condensed Combined Financial Information

As of and for the six months ended 30 June 20X5

	Registrant Historical	ABC Corp. (Acquiree)	Pro Forma Adjustments	Notes	Pro Forma Combined
Short-term debt *	$ -	$ -	$ 60,480	(a)	$ 60,480
Interest expense	18,775	-	1,978	(b)	20,753
For the year ended 31 December 20X4					
Interest expense	37,750	-	3,956	(b)	$ 41,706

* The offsetting balance sheet accounts to this increase to debt will generally comprise the various assets and liabilities being acquired. Those accounts have not been included in this example.

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) Adjustment represents a $63 million bridge loan to finance the cash consideration portion of total consideration, less $2.52 million in debt issuance costs incurred to obtain the bridge loan financing. This obligation is classified as current debt based on its term of one year amortization. See (b) below for the amortization of these issuance costs.

(b) The adjustment to record interest expense assumes the bridge loan was obtained on 1 January 20X4 and was outstanding for the entire year ended 31 December 20X4 and six-months ended 30 June 20X5. The interest rate assumed for purposes of preparing these pro forma financial statements is 2.28%. This rate comprises the one-month LIBOR rate of 0.28% as of 24 August 20X5, plus certain margins specified in the bridge facility agreement. As of 30 September 20X5 one-month LIBOR was 0.27%.

Illustration 6-5: Pro forma adjustments — bridge loan financing (cont'd)

The following adjustments have been recorded to Interest Expense:

	Six months ended 30 June 20X5		Year Ended 31 December 20X4	
Estimated interest expense on bridge loan facility	$	718	$	1,436
Amortization of debt issuance costs associated with bridge facility		1,260		2,520
Total adjustments to interest expense	**$**	**1,978**	**$**	**3,956**

A 1/8% increase or decrease in interest rates would result in a change in interest expense of approximately $0.1 million for the six months ended 30 June 20X5 and approximately $0.2 million for the year ended 31 December 20X4.

In this example, note that although the term of the bridge loan is less than one year, the income statement effects of the bridge loan's interest expense and the amortization of debt issuance costs are reflected in the entire pro forma period of 18 months (from 1 January 20X4 through 30 June 20X5). We believe that reflecting interest expense and amortization for this entire timeframe is reasonable because the bridge financing will be replaced with permanent financing, and interest expense (although likely at a different rate) will have a continuing impact on the registrant.

6.2.1.5 Intangible assets

Pro forma adjustments should be made to reflect the estimated fair value of identified intangible assets acquired based on the estimated purchase price allocation. The pro forma income statement also should be adjusted to reflect the amortization of those intangible assets. In addition, goodwill should be adjusted to eliminate any goodwill that may have been recorded by the acquiree and to reflect the goodwill in the preliminary purchase price allocation.

The examples below illustrate adjustments for identified intangible assets.

Illustration 6-6: Pro forma adjustments — intangible assets and amortization expense

A Company has preliminarily identified and valued approximately $104.6 million in intangible assets acquired in a business combination as of 24 August 20X5 (the closing date of the acquisition and date of the purchase price allocation). They include trade names, customer relationships and technology.

The Company might provide the following pro forma financial information and disclosures related to an acquisition, assuming that changes in its intangible assets, goodwill and amortization expense are the only pro forma adjustments affecting these line items (in thousands):

Unaudited Pro Forma Condensed Combined Financial Information

As of and for the six months ended 30 June 20X5

	Registrant Historical		ABC Corp. (Acquiree)		Pro Forma Adjustments		Notes	Pro Forma Combined	
Intangible assets*	$	–	$	26,625	$	78,015	(a)	$	104,640
Goodwill*		281,000		25,460		146,463	(b)		452,923
Amortization expense		–		2,219		4,061	(a)		6,280
For the year ended 31 December 20X4									
Amortization expense		–		4,438		8,123	(a)		12,561

* The offsetting entries for this adjustment to intangible assets and goodwill would be the other accounts adjusted to reflect the

purchase price allocation for the acquisition. Those accounts are not presented here.

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) Reflects the adjustment of historical intangible assets acquired by the Company to their estimated fair values. As part of the preliminary valuation analysis, the Company identified intangible assets, including technology, trade names, and customer relationships. The fair value of identifiable intangible assets is determined primarily using the "income approach," which requires a forecast of all of the expected future cash flows. Since all information required to perform a detailed valuation analysis of ABC Corp.'s intangible assets could not be obtained as of the date of this filing, for purposes of these unaudited pro forma condensed combined financial statements, the Company used certain assumptions based on publicly available transaction data for the industry.

The following table summarizes the estimated fair values of ABC Corp.'s identifiable intangible assets and their estimated useful lives and uses a straight line method of amortization:

	Estimated Fair Value	Estimated Useful Life in Years	Annual 20X4 Amortization Expense	Six months ended 30 June 20X5 Amortization Expense
Technology	67,500	10.0	6,750	3,375
Trade Names	28,300	7.0	4,043	2,021
Customer Relationships	8,840	5.0	1,768	884
	$ 104,640		12,561	6,280
Historical amortization expense			(4,438)	(2,219)
Pro forma adjustments			**$ 8,123**	**$ 4,061**

These preliminary estimates of fair value and estimated useful lives will likely differ from final amounts the Company will calculate after completing a detailed valuation analysis, and the difference could have a material effect on the accompanying unaudited pro forma condensed combined financial statements. A 10% change in the valuation of intangible assets would cause a corresponding increase or decrease in the balance of goodwill and annual amortization expense of approximately $1.3 million, assuming an overall weighted-average useful life of 8.3 years.

(b) Reflects adjustment to remove ABC Corp.'s historical goodwill of $25.5 million and record goodwill resulting from the Acquisition of $171.9 million.

It's important to note the difference in the assumed timing of the acquisition that should be used for the income statement versus the balance sheet in this example. For the balance sheet adjustment, the intangible assets are reflected at their estimated fair value of $104.6 million as of 30 June 20X5. No adjustment is made to catch up or reflect accumulated depreciation as of 30 June 20X5 as if the acquisition had occurred as of the beginning of the earliest annual period, 1 January 20X4.

In each of the income statement periods, the individual fair values as of the actual or assumed purchase price date are used to calculate the pro forma amortization for those periods as if the acquisition had occurred as of the beginning of the earliest period presented. The intangible assets' fair values should not be recalculated as if the acquisition had occurred as of the beginning of the earliest income statement period presented; instead, the fair value as of the actual or assumed purchase price allocation date is simply pushed back.

It may be helpful to provide sensitivity ranges to state the variability in amortization expense if the fair value estimates for the intangible assets are preliminary. It's possible that as of the filing of the pro forma financial statements, an acquirer may not have completed valuations to determine the fair values. The disclosures related to the preliminary purchase price allocation and/or the adjustments should address the sensitivity of the pro forma income statement to material changes. See Section 4.2.2 for an example of this type of sensitivity analysis.

As shown above, the expected useful lives of significant intangible assets acquired should be disclosed in the notes to the pro forma financial statements. If the amortization of identified intangibles is not straight-line, the effect on operating results for the five years after the acquisition should be disclosed if it's material.

6.2.1.6 Long-lived tangible assets

Pro forma adjustments should be made to reflect the adjustment of an acquiree's long-lived tangible assets (e.g., property, plant and equipment (PP&E)) to fair value based on the estimated purchase price allocation. The pro forma income statement also should be adjusted to reflect depreciation expense based on that estimated fair value. The expected useful lives of significant PP&E acquired should be disclosed in a note to the pro forma financial statements. The pro forma adjustments for acquired tangible assets are very similar in nature to those discussed above for intangible assets.

As discussed above for intangible assets, the adjustment to record a step up to fair value of PP&E should push back the value determined in the preliminary purchase price to the most recent balance sheet. The related depreciation effects of the fair value adjustment should be reflected as if the fair value as of the acquisition date was recognized as of the beginning of the earliest period reflected in the pro forma income statements.

Sensitivity ranges to state the variability in depreciation expense may be necessary if the fair value used for PP&E is preliminary. It's possible that as of the filing of the pro forma financial statements, an acquirer may not have clarity about the fair value. In this situation, a registrant shouldn't state that carrying value of acquired PP&E approximates fair value if that statement is not a fair representation of the assets' fair values. Instead, the disclosures related to the preliminary purchase price allocation and/or the adjustments should clarify the underlying assumption (e.g., "The Company has not yet determined the fair value of PP&E acquired; therefore, carrying value has been used in the preliminary purchase price allocation and in the pro forma financial statements").

6.2.1.7 Transaction costs

An acquirer typically incurs various acquisition-related costs in connection with a business combination. The FASB believes that acquisition-related costs are not part of the fair value exchange between the buyer and seller for the acquired business. Costs that are directly related to the transaction (e.g., costs of services of lawyers, investment bankers, accountants, costs of maintaining an internal acquisition department) are expensed in the periods in which costs are incurred and the services are received.

Making pro forma adjustments for a business combination's transaction costs generally depends on whether the transaction costs are recognized in the registrant's or the acquiree's historical income statement. Costs not reflected in the historical income statements that are directly attributable to the transaction and factually supportable but nonrecurring (e.g., one-time, direct and incremental transaction costs) normally should only be reflected in the pro forma balance sheet as pro forma adjustments to retained earnings. Transaction costs that are recognized in an acquirer's or acquiree's historical financial statements should be eliminated from pro forma income statements because they are nonrecurring charges that are directly attributable to a transaction. The following examples illustrate pro forma adjustments that may be appropriate for transaction costs.

Illustration 6-7: Pro forma adjustments — transaction costs

Transaction costs of $2.5 million that are directly attributable to a business combination are recognized in the historical financial statements of the acquirer for the six month period ended 30 June 20X5. In addition, the acquiree, XYZ Company, recognized $0.25 million of transaction costs that are directly attributable to the same business combination during this same period.

The acquirer may provide the following pro forma financial information and disclosures related to the XYZ Company acquisition, assuming that the effect of transaction costs is the only pro forma adjustment affecting these line items (in thousands):

Unaudited Pro Forma Condensed Combined Financial Information

As of and for the six months ended 30 June 20X5

	Registrant Historical	XYZ Company (Acquiree)	Pro Forma Adjustments	Notes	Pro Forma Combined
Accrued liabilities/cash	$ 3,000	$ 500	$ –		$ 3,500
General & administrative expenses	25,000	1,250	(2,750)	(a)	23,500

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) Represents the elimination of nonrecurring transaction costs incurred during the six-month period ended 30 June 20X5 of $2.75 million that are directly related to the acquisition of XYZ Company.

Analysis:

Transaction costs expensed in connection with a business combination generally are nonrecurring in nature and would not reflect expenses of the combined entity on an ongoing basis (i.e., they are direct and incremental costs that would not have a continuing impact). Such expenses meet the directly attributable and the factually supportable criteria because they (1) directly pertain to and must be incurred to complete the transaction that the pro forma financial information reflects (i.e., the business combination) and (2) have been incurred.

Because the $2.5 million of transaction costs in the acquirer's income statement as well as the $0.25 million included in XYZ Company's income statement will not have a continuing impact on the combined entity, both amounts should be eliminated from expenses (as explained in footnote (a) above) to derive the pro forma G&A expense amounts. For the balance sheet, the $2.75 million is already reflected as of 30 June 20X5 — either through past cash payments or in accrued liabilities. Because the continuing impact criterion only pertains to the income statement, no adjustment is necessary to back out transaction costs in the balance sheet.

Transaction costs not yet recognized in the historical financial statements

In some cases, transaction costs that are directly attributable to a business combination are incurred by either the acquirer or the acquiree or both but have not yet been expensed in the historical income statements or accrued in the balance sheet used as the starting point for the pro forma financial statements.

These transaction costs would meet both the directly attributable (must be incurred to complete the transaction that the pro forma financial information is giving effect to) and factually supportable (have been recognized in subsequent periods) criteria. However, such expenses would not meet the continuing impact criterion because they would not be expenses that the combined entity would expect to incur on an ongoing basis. Therefore, a pro forma adjustment should *not* be made to include those expenses in the pro forma income statement.

Revisiting the illustration above, if the $2.75 million of transaction costs had been incurred after 30 June 20X5, this amount should only be included as an adjustment to the pro forma balance sheet to increase accrued liabilities and decrease retained earnings. No adjustment should be made to the pro forma income statement.

Transaction costs recognized in the historical financial statements for other acquisitions

An acquirer or acquiree entity may have recognized transaction costs related to previous acquisitions unrelated to the business combination to which the pro forma financial statements are giving effect. Such transaction costs generally should not be eliminated through an adjustment in the pro forma income statement reflecting the acquirer's purchase of the acquiree as they are not directly attributable to the transaction for which the registrant is presenting pro forma financial information.

6.2.1.8 Gains and losses attributable to the acquisition

Certain gains or losses may be incurred by an acquirer in connection with an acquisition. Certain items such as bargain purchase gains and gains/losses recognized for acquisitions achieved in stages may be part of the purchase price allocation. Other gains or losses may be recognized outside of purchase accounting. These might include gains/losses recognized from the settlement or termination of pre-existing relationships before or upon completion of an acquisition (e.g., settlement of a contractual relationship such as a lease between an acquirer and acquiree or a noncontractual relationship such as an ongoing lawsuit between those same parties).

Nonrecurring gains and losses that are directly attributable to the transaction and are factually supportable normally should only be reflected in the pro forma balance sheet as pro forma adjustments to retained earnings. Because they would not have a continuing impact on the combined entity, such gains or losses should not be included as adjustments in the pro forma income statements for periods prior to consummation of the acquisition. If the pro forma financial information includes a period subsequent to the consummation of the acquisition, it would be appropriate to eliminate such gains or losses as an adjustment to the pro forma income statement only.

Illustration 6-8: Pro forma adjustments — bargain purchase gain

In rare circumstances, the acquirer's purchase price for the acquiree is less than the fair value of the identifiable net assets acquired. Such a transaction results in a bargain purchase gain being recognized as part of the purchase price allocation instead of goodwill. Such a gain would be considered directly attributable and factually supportable and should be reflected in the pro forma balance sheet. However, such a gain would not have a continuing impact and should not be included in any pro forma income statements.

An acquirer might provide the following pro forma financial information and disclosures related to the ABC Company acquisition, assuming that the bargain purchase gain of $5 million (after tax) is the only pro forma adjustment affecting the following line item (in thousands):

Unaudited Pro Forma Condensed Combined Financial Information

As of 30 June 20X5

	Registrant Historical	ABC Company (Acquiree)	Pro Forma Adjustments	Notes	Pro Forma Combined
Retained earnings	$ 280,000	$ 80,000	$ 5,000	(a)	$ 365,000

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) Represents preliminary bargain purchase gain, net of deferred tax, calculated as if the net assets were acquired on 30 June 20X5. This bargain purchase gain is not reflected in the unaudited pro forma combined statements of operations because it is a nonrecurring item that is directly related to the transaction.

Analysis:

A bargain purchase gain would be reflected in the pro forma balance sheet, as illustrated above, and the offsetting entries to this credit to retained earnings, while not displayed here, would be reflected in the net assets acquired for which adjustments would be made as well as any cash paid or debt incurred for the acquisition.

If the income statement periods presented were to include the $5 million bargain purchase gain in them, a pro forma adjustment would be made to eliminate its effect from the pro forma income statement.

6.2.1.9 Impairment charges in historical financial statements

Registrants should include in the pro forma financial information (i.e., not eliminate with a pro forma adjustment) infrequent or nonrecurring items that are included in either its underlying historical financial statements or those of the acquired entity unless such items are directly attributable to the business combination.

While we believe that it may be appropriate to treat impairment charges previously recognized on acquired assets like historical depreciation and amortization (i.e., appropriate to eliminate), the SEC staff previously expressed a view that historical impairment charges resulting from events unrelated to the business combination should not be eliminated from pro forma financial statements. For example, the SEC staff may object if a registrant removes impairment charges or losses included in the acquired entity's historical financial statements related to the following assets:

- Intangible assets, including goodwill
- Property, plant and equipment
- Loans (e.g., provisions for loan losses)
- Inventory (e.g., lower of cost or market losses)

Illustration 6-9: Goodwill and intangible asset impairment charges

A registrant is preparing pro forma financial information related to its acquisition of ABC Company in February 20X5. ABC Company's historical financial statements include the following intangible asset amortization and impairment charges for the year ended 31 December 20X4:

$ 10 million	Normal intangible asset amortization expense
15 million	Impairment charge related to customer intangible assets
30 million	Impairment charge related to goodwill
$ 55 million	Total intangible asset amortization and impairment charges

The registrant records purchase accounting adjustments to reflect the estimated fair value of $60 million related to the acquired intangible assets, which will result in annual amortization expense of $15 million and implied goodwill fair value of $5 million.

Analysis:

Because the historical impairment charges are not directly attributable to the business combination, the SEC staff may object to eliminating these charges in the pro forma financial information (even if the historical impairment charge exceeds the estimated fair value of the acquired asset). Therefore, the pro forma income statement would reflect the estimated pro forma amortization expense of $15 million related to the acquired intangible assets and the impairment charges of $45 million related to intangible assets and goodwill included in ABC Company's historical financial statements.

An alternative view would be to record an adjustment to eliminate the $45 million of historical impairment charges and record an additional $5 million of amortization expense ($15 million less $10 million of historical amortization expense).

6.2.1.10 Inventory valuation

Acquired inventory balances are recognized at fair value under ASC 820, *Fair Value Measurement*. Accordingly, the pro forma balance sheet should include a pro forma adjustment to step up the inventory balance to fair value consistent with the purchase price allocation. However, when preparing the pro forma income statement, a registrant should only present an adjustment for items with a continuing impact (i.e., generally those that affect the results of operations for a period greater than 12 months). Therefore, we believe the amortization of any inventory step-up that will be fully recognized within a year (based on expected inventory turnover) would not require an adjustment in the pro forma income statement.

The following example illustrates disclosure about a pro forma adjustment to inventory in the pro forma balance sheet that does not have a continuing impact.

Illustration 6-10: Inventory valuation adjustment

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) This adjustment represents the estimated adjustment to step up Target XYZ's finished goods and work in process inventory to a fair value of approximately $9 million, an increase of $2.5 million from the carrying value. The fair value calculation is preliminary and subject to change. The fair value was determined based on the estimated selling price of the inventory, less the remaining manufacturing and selling costs and a normal profit margin on those manufacturing and selling efforts. After the acquisition, the step-up in inventory fair value of $2.5 million will increase cost of sales over approximately two months as the inventory is sold. This increase is not reflected in the pro forma condensed combined statements of operations because it does not have a continuing impact.

6.2.1.11 Deferred revenue

An acquired company may have recorded deferred revenue in its historical, pre-acquisition financial statements for a number of reasons. For example, these amounts could represent up-front payments for services or products the acquired company has not yet delivered or payments for delivered goods or services sold as a part of a multiple-element arrangement that could not be accounted for separately. In a business combination, the acquiring entity recognizes the acquired company's deferred revenue only if it relates to a legal performance obligation assumed by the acquiring entity. The measurement of the assumed performance obligation is at fair value at the date of acquisition, pursuant to the guidance in ASC 820. Therefore, in certain situations, the acquirer may write off the entire deferred revenue balance of the acquired company.

When preparing the pro forma income statement, we believe that registrants should evaluate whether the pro forma adjustment to reflect the fair value of acquired deferred revenue (or the write-off of the entire deferred revenue balance) has a continuing impact (i.e., it affects the results of operations for a period greater than 12 months). The following example illustrates disclosure when a registrant reflects the pro forma adjustment in the pro forma balance sheet and income statement because the adjustment has a continuing impact:

Illustration 6-11: Deferred revenue adjustment

A calendar-year registrant acquires Target XYZ on 25 August 20X5 and is filing pro forma financial information for the significant business combination in a Form 8-K. As of the acquisition date and 30 June 20X5, Target XYZ recognized deferred revenue of $35 million related to various extended maintenance arrangements for which it has a legal obligation to provide service over approximately two years. The registrant calculated a fair value of $20 million for this assumed obligation.

The registrant might make the following pro forma adjustments for deferred revenue and the related disclosures in the pro forma financial information (in thousands):

Unaudited Pro Forma Condensed Combined Financial Information

As of and for the six months ended 30 June 20X5

	Registrant Historical	Target XYZ (Acquiree) Historical	Pro Forma Adjustments	Notes	Pro Forma Combined
Revenue	$ 243,200	$ 79,430	$ (3,500)	(a)	$ 319,130
Deferred revenue	–	34,600	(15,000)	(a)	19,600
For the year ended 31 December 20X4					
Revenue	472,520	151,310	(8,900)	(a)	614,930

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) This adjustment represents the estimated adjustment to decrease the assumed deferred revenue obligations to a fair value of approximately $20 million, a reduction of $15 million from the carrying value. The calculation of fair value is preliminary and subject to change. The fair value was determined based on the estimated costs to fulfill the remaining extended maintenance obligations plus a normal profit margin. After the acquisition, this adjustment will have a continuing impact and will reduce revenue related to the assumed performance obligations as the maintenance services are provided over the next two years. The pro forma adjustments to reduce revenue by $3.5 million for the six months ended 30 June 20X5 and $8.9 million for the year ended 31 December 20X4 reflect the difference between prepayments related to extended maintenance arrangements and the fair value of the assumed performance obligations as they are satisfied, assuming the transaction was consummated on 1 January 20X4.

Analysis:

The fair value adjustment to reduce acquired deferred revenue by $15 million is reflected in the pro forma balance sheet assuming the business combination occurred on 30 June 20X5. However, for purposes of the pro forma income statement, the registrant assumes the transaction occurred on 1 January 20X4. Therefore, the registrant calculated the pro forma adjustments to revenue by estimating the reduction arising from the difference between prepayments related to extended maintenance arrangements and the fair value of the assumed performance obligations as they are satisfied over the expected two year service period: $8.9 million was estimated over the next 12 months and $3.5 million over the following six months.

6.2.1.12 Research and development expenses

Under ASC 805, acquired in-process research and development (IPR&D) assets are not permitted to be written off upon acquisition. Instead, acquired IPR&D assets are required to be measured at their acquisition-date fair value and considered indefinite-lived intangible assets until the completion or abandonment of the associated R&D efforts.

Acquired IPR&D assets may include projects for which the acquired entity incurred R&D expenses in its pre-acquisition historical financial statements. However, the SEC staff has said that it is not appropriate to adjust the amounts of historical R&D expense because those costs are not directly related to the acquisition, and the registrant may record ongoing expenses to complete the in-process R&D project in its post-acquisition financial statements.[13]

6.2.1.13 Deferred tax asset valuation allowances

A business combination may result in changes to the valuation allowance recorded on either the registrant's or the acquired entity's deferred tax assets. As a result, adjustments may be necessary to reflect the pro forma effect on the combined entity's deferred tax assets and income tax provision or benefit.

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[13] SEC staff's Financial Reporting Manual Section 3250.g.

For example, prior to a business combination, the registrant, after considering all available positive and negative evidence, may have concluded that a valuation allowance was required on its deferred tax assets. However, deferred tax liabilities assumed in a business combination may be available to offset the reversal of the acquirer's pre-existing deferred tax assets. Under ASC 805-740, a change in an acquirer's valuation allowance for a deferred tax asset that results from a change in the acquirer's circumstances caused by a business combination should be accounted for as an event separate from the business combination. As a result, changes in the acquirer's valuation allowance that stem from a business combination are recognized as an income tax benefit in the period the business combination is consummated.

On the other hand, the acquired entity may have recorded a valuation allowance in its historical financial statements. If subsequent to a business combination the combined entity expects to file a consolidated tax return, an assessment of the need for, and amount of, a valuation allowance would be based on the combined entity's past and expected future results of operations as of the acquisition date. Pre-existing deferred tax liabilities of the acquirer or other sources of income of the combined entity may be available to realize the acquired deferred tax assets. Changes to the acquiree's valuation allowance are accounted for as part of the business combination and not as an income tax benefit.

Further guidance about the accounting for income tax valuation allowances in a business combination is described in the EY publication, *Financial reporting developments: Income taxes*.

The registrant should consider the effects of the business combination on the valuation of deferred tax assets in the pro forma financial information and include a pro forma adjustment if it concludes a reduction in the valuation allowance is directly attributable to the transaction, including:

- The registrant should reflect a pro forma adjustment to reduce the registrant's or acquired entity's valuation allowance in the pro forma balance sheet.
- A pro forma adjustment for the reduction of the valuation allowance on the acquirer's deferred tax assets as a result of the acquisition often would be inappropriate in the pro forma income statement because its effect is nonrecurring. However, the registrant should clearly disclose that the income tax benefit related to the reduction of its valuation allowance is not included in the pro forma income statement.
- The registrant may need to adjust the pro forma income statement to reflect the continuing effect of the transaction on the combined entity's pro forma income tax provision or benefit that is factually supportable (e.g., the income tax benefit related to the registrant's or acquired entity's historical pretax losses that previously could not be recognized due to the need for a valuation allowance). Additional guidance about the income tax effects of pro forma adjustments is discussed at Section 6.2.8.1.

Illustration 6-12: Pro forma adjustments — change in registrant's valuation allowance

A calendar-year registrant, after considering all available evidence, concluded that a valuation allowance of $30,000 was required for the full amount of its deferred tax assets as of 31 December 20X4.

On 1 March 20X5, the registrant acquired ABC Company. The registrant recorded significant deferred tax liabilities of $60,000 related primarily to acquired intangible assets that it will amortize for financial reporting purposes. After the acquisition, the registrant will file a consolidated tax return that will include ABC Company. The registrant concluded that the deferred tax liabilities related to the ABC acquisition were sufficient to realize its pre-existing deferred tax assets. Accordingly, the registrant recorded a tax benefit of $30,000 related to the reversal of its valuation allowance in the period the acquisition occurred.

The registrant might provide the following pro forma financial information and disclosures related to the ABC acquisition, assuming that changes in the registrant's valuation allowance are the only pro forma adjustments affecting these line items:

Unaudited Pro Forma Condensed Combined Financial Information

As of and for the year ended 31 December 20X4

	Registrant Historical	ABC Company (Acquiree) Historical	Pro Forma Adjustments	Notes	Pro Forma Combined
Deferred income tax assets	$ -	$ 20,000	$ 30,000	(a)	$ 50,000
(Loss) income before income taxes	(10,000)	15,000			5,000
Income tax (benefit) provision	-	6,000	(4,000)	(b)	2,000
Net (loss) income	$ (10,000)	$ 9,000	$ 4,000		$ 3,000

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) This adjustment reflects the elimination of the Company's deferred tax asset valuation allowance of $30,000. The acquisition of ABC Company results in the recognition of deferred tax liabilities of approximately $60,000 related primarily to amortizable intangible assets (while this requires a pro forma adjustment to reflect the deferred tax liabilities, it is not reflected for purposes of this presentation). Because ABC Company will be included in the Company's consolidated tax return following the acquisition, the Company has determined that the deferred tax liabilities related to the acquisition provide sufficient taxable income to realize the Company's deferred tax assets of $30,000. However, the income tax benefit of $30,000 related to the reduction in the Company's valuation allowance is not reflected in the pro forma statement of operations because it will not have a continuing impact.

(b) As explained in Note a, the acquisition of ABC Company will result in the reversal of the Company's valuation allowance. As a result, the combined entity will benefit its pretax losses (if applicable). This pro forma adjustment reflects the income tax expense related to the combined pro forma pretax income during the year ended 31 December 20X4, based on the statutory tax rate of 40% and calculated as follows.

Pro forma combined income before income taxes	$ 5,000
Statutory tax rate	40%
Pro forma combined income tax provision	2,000
Historical combined income tax provision	6,000
Pro forma adjustment	(4,000)

6.2.1.14 Disposal in connection with business combination

The registrant or its target may expect to dispose of certain operations to gain approval for the business combination from one or more regulatory agencies. The SEC staff believes that the pro forma financial information should reflect these disposals if they can be identified.[14] If the operations that will be disposed of cannot be identified with reasonable certainty when the pro forma financial information is prepared, the notes to the pro forma financial information should disclose any contingencies affecting regulatory approval for the business combination and the reasonably possible effect of expected disposals, if known, on the financial statements. Although the SEC staff does not define or provide examples of disposals that are identifiable with "reasonable certainty," we believe that an acquirer should consider the status of its discussions with regulatory agencies, potential disposals identified in regulatory approval orders, and its past experience to assess whether it is appropriate to make pro forma adjustments for planned disposals.

Pro forma financial information for such a disposal also should be filed under Item 2.01 of Form 8-K when the disposal occurs if the disposition is significant (e.g., exceeds 10% significance).

Illustration 6-13: Disposal in connection with business combination

A telecommunications registrant has entered into an agreement to acquire XYZ Company. In order to obtain regulatory approval from the Federal Communications Commission (FCC), the registrant proposed a plan to dispose of certain assets within one year of the consummation of the XYZ acquisition. The FCC has approved the registrant's plan by the time pro forma financial information is required in a merger proxy statement. Accordingly, the registrant should make a pro forma adjustment to eliminate the operations related to the planned disposal group in the pro forma financial information.

If the FCC had not approved the registrant's plan when the pro forma information was filed, the registrant would have evaluated whether the disposal operations were identifiable with reasonable certainty. If not, the registrant would not reflect pro forma adjustments but would clearly disclose the necessary regulatory approval to complete the acquisition and the possible effects of the expected disposals in the notes to the pro forma financial information.

6.2.1.15 Compensation arrangements

In connection with business combinations, acquired companies' compensation arrangements are often settled or exchanged for new arrangements. These arrangements may include management contracts, severance agreements, share-based awards or benefit plan arrangements.

Change-in-control provisions

Change-in-control provisions in employment or compensation agreements may result in the acceleration of share-based awards or one-time cash settlement payments upon consummation of a business combination. Compensation charges for such provisions may be included in the acquiree's pre-acquisition or acquirer's post-acquisition financial statements, depending on the facts and circumstances. For example, the preexisting terms of the acquiree's share-based awards may contain change-in-control provisions that result in the automatic acceleration of all unvested awards immediately prior to the acquisition. If a change-in-control provision is added to an acquiree's share-based awards in contemplation of the business combination, the acquirer generally would expense the cost in its financial statements following the acquisition.[15]

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[14] SEC staff's Financial Reporting Manual Section 3250.I.

[15] A modification to share-based payment awards that adds a change-in-control provision in contemplation of a business combination requires a careful analysis of all of the facts and circumstances related to the terms of the acquiree awards. In general, we believe such a modification that is initiated by the acquirer or is subject to the approval of the acquirer is primarily for the benefit of the combined entity and therefore should be accounted for as a separate transaction (i.e., as postcombination compensation cost).

If the change-in-control provisions result, or will result, in nonrecurring charges in either the acquiree's or acquirer's financial statements, the pro forma income statement should exclude these amounts because they are directly related and factually supportable but do not have a continuing impact. However, the acquirer generally should not reflect pro forma adjustments to remove any other elements of the historical compensation expense of the acquired entity. When the acquirer does not plan to replace the target's share-based awards that are settled as part of the transaction, it generally would be inappropriate to remove the historical share-based compensation expense of the target.

Illustration 6-14: Change-in-control provisions

Example 1: Double-trigger arrangements

In connection with a registrant's acquisition of Target XYZ, certain executive officers of Target XYZ are expected to receive severance and other separation benefits related to existing employment agreements with double-trigger provisions. These double-trigger agreements result in cash payments to the executives following two events: a change-in-control and termination or reduction in the responsibilities of the executives. The registrant decided to terminate these executives following the business combination. Because the double-trigger agreements require an action by the acquirer, ASC 805 requires the payments to be recorded as post-combination compensation expense in the registrant's financial statements. However, the registrant concludes that these charges are directly attributable to the business combination.

These charges should be excluded from the pro forma income statement because they reflect charges directly attributable to the merger that will not have a continuing impact on the registrant's operations; however, they should be reflected in the pro forma balance sheet because they are directly attributable and factually supportable. In addition, it generally would be inappropriate to reflect pro forma adjustments to exclude or reduce the historical compensation expense of these terminated executives in Target XYZ's financial statements because the effects of their termination on the combined entity's operations are too uncertain. Refer to Section 6.2.1.16 for further discussion of pro forma adjustments related to restructuring activities.

Example 2: Share-based compensation awards

Target XYZ modifies its share-based compensation awards to include a change-in-control provision in contemplation of its acquisition by the registrant. In order to foster an effective transition for Target XYZ's employees, the registrant initiated the modification to these awards as part of its negotiations. The change-in-control provision results in the acceleration of all unvested share-based awards with no additional service requirements. The registrant will recognize a compensation charge immediately after the business combination that it will reflect in the pro forma balance sheet, but it will not reflect this amount as a pro forma adjustment in the pro forma income statement because the adjustment does not have a continuing impact.

The registrant might make the following pro forma adjustment disclosures to reflect the acceleration of the share-based awards.

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) The Company expects to record post-combination compensation expense of $7 million related to its decision to accelerate the unvested share-based awards of Target XYZ in contemplation of the merger. This amount is excluded from the unaudited pro forma condensed combined statements of operations because it is a charge directly attributable to the merger that will not have a continuing impact on the Company's operations; however, the amount is reflected as a reduction to retained earnings in the unaudited pro forma balance sheet.

Example 3: Inappropriate pro forma adjustments

A registrant consummates a significant business acquisition of Target XYZ. Target XYZ's existing stock compensation arrangements that cover all employees contain change-in-control provisions that result in the acceleration of all unvested equity awards on the acquisition date. All employees of Target XYZ are continuing as employees of the registrant. The registrant does not currently have a stock compensation plan other than for its officers and directors. In addition, the registrant has not executed new employment agreements with any of the Target XYZ employees.

Although the registrant will not issue share-based awards to any of the Target XYZ employees, it would be inappropriate to reflect a pro forma adjustment to remove all share-based compensation expense in Target XYZ's historical financial statements. The effects of different compensation levels are unlikely to be factually supportable. The registrant has not finalized new compensation arrangements with the Target XYZ employees, and a decision to lower the total compensation of these employees could have related effects on the registrant's combined revenue or operations.

New or replacement compensation agreements

Generally, new compensation contracts with management or employees of the acquired business would require pro forma adjustments only if the new contract is entered into as part of the business combination. For example, merger agreements frequently specify the exchange of share-based payments (stock, stock options and similar instruments) held by employees of the target for equity instruments of the acquiring company. The guidance in ASC 805 states that exchanges of share-based payments in a business combination are accounted for as modifications in accordance with the provisions of ASC 718. New or exchanged awards that result in a significant change in ongoing compensation expense for these employees may result in pro forma adjustments. Similarly, new employment agreements that are executed as part of the merger agreement could affect the annual compensation of certain employees of the acquired business.

The acquirer also may execute other arrangements such as new distribution, cost sharing, management fee agreements or benefit plans that are directly attributable to the business combination.

Illustration 6-15: New compensation arrangements

As part of the registrant's acquisition of Target XYZ, the registrant executed new compensation arrangements with five key executives of Target XYZ who will continue as employees of the registrant. These compensation agreements result in annual salary increases and one-time bonuses (cash as well as fully vested restricted stock units).

In addition, the registrant also issued new share-based awards to the employees of Target XYZ that replace their unvested Target XYZ stock-based awards. The replacement share-based awards vest over post-combination service periods that range from two to three years.

The registrant concluded that these new compensation arrangements were directly attributable to the acquisition and factually supportable because the arrangements were executed as part of the merger agreement.

The registrant might make the following disclosures about the pro forma adjustments.

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) This adjustment reflects new compensation arrangements executed with five key executives in connection with the business combination, resulting in a $2.5 million increase in the annual compensation for these executives from their previous compensation, which is reflected in the pro forma statement of operations. However, the pro forma statement of operations does not include $1 million in bonuses and $2 million for the value of restricted stock units granted to these executives, which were payable and fully vested upon closing of the business combination, because these items will not have a continuing impact on operations.

(b) The pro forma adjustment for share-based awards represents the difference between Target XYZ's historical share-based compensation expense and the estimated share-based compensation expense related to replacement awards issued to continuing employees as part of the acquisition agreement. The fair value of the replacement share-based awards, including stock options and restricted stock units, will be recognized ratably over post-combination service periods ranging for two to three years.

6.2.1.16 Restructuring activities

Costs associated with restructuring or exit activities that are not obligations of the target are accounted for separately from the business combination under ASC 805, generally as post-combination expenses of the combined entity when incurred. In many situations, pro forma adjustments related to these activities do not meet the directly attributable or factually supportable criteria to reflect in the pro forma financial information.

Historical restructuring charges

If the historical income statement includes a material restructuring provision (which resulted prior to the business combination), it is not appropriate to remove the historical restructuring provision as a pro forma adjustment. Such an adjustment would not be directly attributable to the transaction. In such a situation, it may be desirable to provide disclosure about the restructuring similar to that included in the related historical financial statements.

Disposal or termination of revenue-producing activities

As part of the business combination, management formulates and commits to a plan to dispose of or terminate revenue-producing activities. It is appropriate to present pro forma adjustments depicting the recurring effects of exiting revenue-producing activities if they are determined to be directly attributable to the transaction and factually supportable. That type of pro forma adjustment is consistent with the requirement to provide pro forma information depicting material dispositions as discussed in Section 6.2.2 and planned disposals subject to regulatory approval discussed in Section 6.2.1.14. Only revenues and costs specifically identified with that revenue-producing activity may be included in the pro forma adjustments. Allocations of corporate costs should not be included in a pro forma adjustment for the disposition.

Other actions to be taken by management

Pro forma adjustments usually should not reflect actions taken by management (or expected to be taken) after a business combination related to the integration and management of the acquired business. Management often terminates employees or closes facilities after a business combination to eliminate costs perceived as redundant. The SEC staff views adjustments for those types of actions to be forecasts or projections because their timing and effects generally are too uncertain to be considered factually supportable.[16] For example, a company would not be able to eliminate compensation expense on a pro forma basis for employees terminated in conjunction with a business combination because the related effects on revenues and operations would be too uncertain.

If the registrant expects cost savings that are not reflected in the pro formas, a discussion of the expected cost savings may be included in management's discussion and analysis or disclosed and clearly identified as forward-looking in the pro forma financial information. For example, the following is an illustration of possible disclosure about estimated cost savings in the pro forma financial information:

Illustration 6-16: Cost savings related to restructuring activities

Notes to Unaudited Pro Forma Condensed Combined Financial Information

The combined pro forma financial information does not reflect the realization of any expected cost savings or other synergies from the acquisition of Target XYZ as a result of restructuring activities and other cost savings initiatives.

The Company currently estimates that synergies and planned restructuring activities will result in annual combined cost savings of approximately $8 million to $12 million, which are not reflected in the pro forma condensed consolidated statements of operations. Although the Company believes such cost savings and other synergies will be realized following the business combination, there can be no assurance that these cost savings or any other synergies will be achieved in full or at all. In addition, the pro forma financial information does not reflect the planned restructuring charges associated with these cost savings, which are expected to be expensed in the Company's statement of operations.

[*Note: The Company's pro forma financial information also should include appropriate cautionary language about the forward-looking statements related to the projections of synergies and cost savings to meet the safe harbor under the Private Securities Litigation Reform Act of 1995.]*

6.2.1.17 Accounting policy conformity changes

Pro forma adjustments are necessary to conform the accounting policies of the acquired business to those of the registrant for all periods presented, if material. In addition, the registrant often must reflect reclassification adjustments to conform the historical financial statement presentation of the acquired business to that of the registrant. The registrant may reflect reclassification adjustments in a separate column or combined with other pro forma adjustments provided there is appropriate disclosure in the notes to the pro forma financial information.

[16] SEC staff's Financial Reporting Manual Section 3250.e.

The following illustration provides excerpts of possible pro forma disclosures to reflect adjustments to conform the presentation of the registrant and an acquired business:

Illustration 6-17: Conforming accounting policies and classification

Unaudited Pro Forma Condensed Combined Financial Information

For the year ended 31 December 20X4

	Registrant Historical	Target XYZ Historical	Reclassification Adjustments (Note 4)		Transaction Adjustments		Pro Forma Combined
Revenues	$ 120,500	$ 48,000	$ –		$ –		$ 168,500
Cost of revenues	63,000	24,500	2,500	4a	(3,000)	3a	87,000
Selling and administrative expenses	11,500	10,000	(2,500)	4a	–		19,000

[All other financial statement line items excluded for presentation purposes]

Notes to Unaudited Pro Forma Condensed Combined Financial Information

Note 3 Transaction adjustments

(a) The Company defers certain direct and incremental costs for delivered products prior to the recognition of revenue. Because Target XYZ has an accounting policy to expense these costs as incurred, this pro forma adjustment reflects the net change in the amount of deferred costs during the period to conform Target XYZ's accounting policy to that of the Company.

Note 4 Reclassification adjustments

Certain reclassifications have been made to the historical presentation of Target XYZ to conform to the financial statement presentation of the Company, as follows:

(a) The Company recognizes all shipping and handling costs in cost of revenue, while Target XYZ recognizes these costs in selling and administrative expenses. Therefore, this adjustment conforms the presentation of shipping and handling costs to the Company's presentation.

When the registrant expects to adopt a new accounting principle, the SEC staff has said that pro forma financial information, presented before the registrant reflects the accounting change in its historical financial statements (i.e., interim financial statements reflecting the new accounting principle have not been filed), does not require pro forma adjustments to reflect adoption of the new accounting principle. Instead, the SEC staff has said that the disclosure requirements under SAB Topic 11.M are appropriate to explain the potential effects of the recently issued accounting standard in the registrant's registration statement or periodic reports.

If a retrospective change in accounting principle is reported in the registrant's interim financial statements, there may be questions about whether pro forma adjustments are necessary to reflect the accounting principle in pre-adoption periods. For example, when pro forma financial information is presented for a significant business combination the registrant may not yet have recast its annual financial statements to reflect the retrospective change in accounting principle (e.g., recasted annual financial statements may not be required until the next Form 10-K filing). We do not believe it would be necessary to reflect the accounting change in the pro forma financial information for the pre-adoption annual period provided that the accounting policies of the registrant and acquired business are consistent for that pro forma period, because the pro forma financial information is intended to reflect the effects of the significant business combination rather than a retrospective accounting change (and the change is not directly attributable to the business combination). However, if the pro forma annual period and interim period reflect different accounting principles, the notes to the pro forma financial statements should clearly disclose that fact and the effect of the adoption of the new accounting principle on the pro forma interim period. Of course, the registrant could elect to include a pro forma adjustment in the annual period to reflect the estimated retrospective effects of the accounting change on both the acquirer and acquiree.

The following examples illustrate different scenarios when the registrant prepares pro forma financial information for a significant business combination after adopting a new accounting principle:

Illustration 6-18: Adoption of new accounting principles

Example 1: New accounting principle not yet reflected in interim financial statements

In April 20X5, ABC Inc. (the Company), a calendar-year registrant, completes a significant business acquisition of Target XYZ for which pro forma financial information on Form 8-K is required for the fiscal year ended 31 December 20X4. The Company adopted a new accounting principle on 1 January 20X5 that will require retrospective application, but the Company has not yet filed its first quarter 20X5 financial statements reflecting the new accounting principle.

Analysis:

The Company is not required to reflect the pro forma effects of the new accounting principle on the pro forma financial information as of and for the year ended 31 December 20X4. The Company should conform the existing accounting policies of ABC Inc. and Target XYZ prior to adoption of the new accounting principle, as appropriate, in its pro forma financial information. In addition, the Company may include or reference in the notes to its pro forma financial information the disclosures required by SAB Topic 11.M that explain the effects of adopting the new accounting principle.

Example 2: New accounting principle reflected in interim financial statements

In June 20X5, ABC Inc. (the Company), a calendar-year registrant, completes a significant business acquisition of Target XYZ. The Company will file pro forma financial information on Form 8-K for the fiscal year ended 31 December 20X4 and the interim period ended 31 March 20X5. The Company adopted a new accounting principle on 1 January 20X5 that requires retrospective application. The new accounting principle is reflected in the Company's first quarter 20X5 financial statements, but the Company has not yet revised its financial statements for prior annual periods. The annual and interim financial statements of Target XYZ do not reflect the adoption of this new accounting principle.

Analysis:

Because Target XYZ has not reflected the new accounting principle in its interim financial statements, the Company should include a pro forma adjustment for this interim period that conforms the existing accounting principle of Target XYZ to the new accounting principle adopted by the Company. Furthermore, the Company should consider its facts and circumstances to evaluate whether pro forma adjustments reflecting the new accounting principle for the fiscal year ended 31 December 20X4 are appropriate.

Assuming that the accounting principles of the Company and Target XYZ are consistent for the year ended 31 December 20X4, we do not believe that pro forma adjustments are required to reflect the new accounting principle because the pro forma financial information filed on Form 8-K would effectively present the pro forma effects of the business acquisition. In that case, the notes to the pro forma financial information should clearly disclose that the annual and interim periods are presented using different accounting principles and the effect of the accounting change on the pro forma interim period. However, we believe it also would be acceptable to include pro forma adjustments for the new accounting principle if considered meaningful to investors.

6.2.1.18 Foreign acquisition considerations

When a domestic registrant acquires a foreign business (or a foreign private issuer acquires a domestic or foreign business), pro forma adjustments may be necessary to convert the basis of accounting or reporting currency of the acquired business. In addition, refer to Section 5.7 for considerations about the age of pro forma financial information when there is a foreign business acquisition.

Basis of accounting adjustments

The pro forma financial information should reflect the basis of accounting used by the registrant. When a registrant acquires a business that applies a different basis of accounting, pro forma adjustments are required to convert the acquiree's historical financial statements to the registrant's basis of accounting.

Consider the following examples:

- A US domestic registrant acquires a foreign business whose historical financial statements are presented on a comprehensive basis other than US GAAP. Even through the acquiree's financial statements may not require a US GAAP reconciliation (e.g., presented under IFRS as issued by the IASB or local home country GAAP and the acquisition is less than 30% significant), the registrant must reflect adjustments to convert the acquiree's financial statements to US GAAP in the pro forma financial information.
- A foreign private issuer that presents its financial statements under IFRS as issued by the IASB acquires a US business whose financial statements are prepared under US GAAP. The FPI must convert the acquired business financial statements to IFRS in the pro forma financial information.
- A foreign private issuer that presents its financial statements under local home country GAAP with a reconciliation to US GAAP acquires a foreign business that also presents its financial statements under local home country GAAP. The pro forma financial information of the registrant and acquired business should be reconciled to US GAAP (in a manner consistent with Item 17 of Form 20-F). However, the SEC staff generally has not objected if the FPI elects to present the pro forma financial information directly in US GAAP.[17]

In addition, if a registrant acquires another company in a transaction accounted for as a reverse acquisition then the post-acquisition financial statements will generally be those of the legal acquiree. In certain cases, the legal acquiree's basis of accounting could be different than that of the registrant and accordingly will become the basis of accounting for the registrant. For example, in a reverse merger, a foreign private issuer (i.e., registrant and legal acquirer) that reports under IFRS as issued by the IASB as its basis of accounting may acquire a US target (i.e., accounting acquirer and legal acquiree) that reports under US GAAP. In these circumstances, we have seen the SEC staff accept pro forma financial information that applies the basis of accounting of the legal acquiree (accounting acquirer) instead of the registrant.

The SEC staff has said that registrants are not required to present the conversion of the acquired foreign business's balance sheet and income statement to US GAAP (or the registrant's basis of accounting) in a separate column of the pro forma financial information. The SEC staff has said that it will not object if the adjustments to conform to US GAAP and the purchase accounting adjustments are combined for purposes of presentation in the pro forma information provided there is appropriate disclosure in the notes.

Foreign currency adjustments

S-X Rule 3-20, *Currency for financial statements for foreign private issuers*, allows a foreign private issuer to prepare its financial statements in the currency it believes is appropriate, but the rule does not address financial statements of acquired businesses. However, the SEC staff believes that these financial statements can be prepared either in the same currency as the registrant or in the currency that normally is used for preparation of such entities' financial statements.

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[17] SEC staff's Financial Reporting Manual Section 6360.2.

However, all the columns in the pro forma information should be presented using the reporting currency of the registrant. Accordingly, the balance sheet and income statement of an acquired foreign business should be converted to the registrant's reporting currency. A method consistent with ASC 830 generally should be used to translate currencies. The pro forma presentation should disclose the basis for the conversion either in narrative form or in a supplemental schedule to the pro forma information.

Illustration 6-19: Foreign business acquisition

On 1 March 20X5, a US calendar-year registrant acquires Target XYZ, a UK entity that qualifies as a foreign business. Target XYZ has prepared its financial statements in accordance with IFRS as issued by the IASB (and accordingly a reconciliation to US GAAP is not required in its historical financial statements presented to comply with S-X Rule 3-05). In addition, Target XYZ presents its financial statements using British pounds sterling as its reporting currency.

When preparing the pro forma financial information, the registrant must reflect adjustments to convert the target's financial statements to US GAAP and translate the information to its reporting currency of US dollars.

The following example is an acceptable presentation of the registrant's pro forma financial information related to the foreign business acquisition. Note that the illustration only reflects the adjustments and disclosures related to one financial statement line item:

Unaudited Pro Forma Condensed Combined Financial Information

For the year ended 31 December 20X4

	Registrant Historical	Target XYZ Historical IFRS (in £)	Target XYZ Historical IFRS (in USD)	Target XYZ US GAAP Adjustments	Transaction Adjustments	Pro Forma Combined
Income tax (benefit) provision	$ 140,000	£ 50,000	$ 77,500	$ 8,000 (3a)	$ –	$ 225,500

Notes to Unaudited Pro Forma Condensed Combined Financial Information

Note 3 Foreign currency and US GAAP conversion adjustments

The historical financial information of Target XYZ was prepared in accordance with IFRS and presented in British pounds sterling. The historical financial information was translated from British pounds sterling to US dollars using the following historical exchange rates:

	$ / £
Average exchange rate for year ended 31 December 20X4 (statement of operations)	1.55
Period end exchange rate as of 31 December 20X4 (balance sheet)	1.65

In addition, the following adjustments convert Target XYZ's financial information from IFRS to US GAAP and align Target XYZ's accounting policies to those applied by the Company.

(a) This adjustment reflects an additional income tax provision of $8,000 related to IFRS to US GAAP differences for uncertain tax positions. Target XYZ's uncertain tax positions were determined using an expected value or probability-weighted average approach under IFRS instead of a cumulative probability model under US GAAP.

6.2.2 Dispositions

When the disposition of a business is significant (i.e., it exceeds 10% significance), the company is required to file pro forma financial information for the most recent fiscal year and subsequent interim period in a Form 8-K under Item 2.01 (within four business days of the transaction) and in new or amended registration statements. However, as discussed in Section 5.3.1, pro forma condensed income statements are required for all historical financial statement periods presented in a registrant's filing when the pro forma information reflects a disposition that qualifies as a discontinued operation under ASC 205. As discussed in Section 5.3.1.2, if pro forma financial information gives effect to other transactions (e.g., a new contractual arrangement, a reduction in interest expense due to debt repayment) in addition to discontinued operations, the pro forma presentations for the other transactions should be limited to the most recent year and subsequent interim period. Disclosures should clearly describe how transactions are reflected in the periods presented.

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro forma financial information

Instructions to Rule 11-02, Preparation requirements

(3) For a disposition transaction, the pro forma financial information shall begin with the historical financial statements of the existing entity and show the deletion of the business to be divested along with the pro forma adjustments necessary to arrive at the remainder of the existing entity. For example, pro forma adjustments would include adjustments of interest expense arising from revised debt structures and expenses which will be or have been incurred on behalf of the business to be divested such as advertising costs, executive salaries and other costs.

The following example illustrates how a registrant might reflect pro forma adjustments in the pro forma balance sheet and income statement when there is a disposition that does not meet the criteria for a discontinued operation:

Illustration 6-20: Disposition

ABC Co., a calendar-year registrant, completed the sale of its digital business to XYZ Co. on 25 August 20X5 and is filing pro forma financial information for this significant disposition in a Form 8-K. The consideration received by ABC Co. at closing consisted of $40 million in cash.

The registrant might make the following pro forma adjustments and the related disclosures in the pro forma financial information (in millions):

Unaudited Pro Forma Condensed Combined Statement of Operations

For the six months ended 30 June 20X5

	Registrant Historical	Adjustments	Notes	Pro Forma
Revenue	$ 250	$ 50	(a)	$ 200
Cost of goods sold	150	10	(a)	140
Operating and administrative expense	50	30	(b)	20
Provision for income taxes	16	4	(c)	12

(EPS information not included in illustration)

Unaudited Pro Forma Condensed Combined Balance Sheet

As of 30 June 20X5

	Registrant Historical	Adjustments	Notes	Pro Forma
ASSETS				
Cash and equivalents	$ 1,350	$ 40	(d)	$ 1,390
Receivables	300	(50)	(e)	250
Inventories	2,220	(450)	(e)	1,770
Property, plant and equipment	7,700	(560)	(e)	7,140
	11,570	(1,020)		10,550
LIABILITIES				
Accounts Payable and accruals	3,010	(940)	(e)	2,070
Long-term debt	2,300	-		2,300
Deferred income taxes	1,257	(100)	(e)	1,157
	6,567	(1,040)		5,527
EQUITY				
Common shares	3	–		3
Additional paid-in capital	2,000	–		2,000
Retained earnings	3,000	20	(f)	3,020
Total liabilities and equity	11,570	(1,020)		10,550

[Pro forma statement of operations for the year ended 31 December 20X4 is excluded from this illustration]

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) This adjustment reflects the elimination of revenues and cost of goods sold of the digital business.

(b) This adjustment reflects the elimination of operating and administrative expenses. Not included in the pro-forma results are anticipated savings due to costs that may be reduced or eliminated.

(c) This adjustment represents the estimated income tax effect of the pro-forma adjustments. The tax effect of the pro-forma adjustments was calculated using the historical statutory rates in effect for the periods presented.

(d) This adjustment represents the receipt of cash consideration at the closing of the transaction.

(e) These adjustments reflect the elimination of assets and liabilities attributable to the digital business.

(f) This adjustment reflects the gain of $20 million arising from the transaction as of 25 August 20X5. This estimated gain has not been reflected in the pro forma consolidated statement of operations as it is considered to be nonrecurring in nature. No adjustment has been made to the sale proceeds to give effect to any potential post-closing adjustments under the terms of the asset purchase agreement.

6.2.3 Reorganization of entities under common control

Under ASC 805, when entities under common control transfer assets or liabilities to each other, the receiving entity recognizes the assets and liabilities at the carrying amounts in the transferring entity's financial statements on the transfer date. The use of these carrying amounts is required even if the fair value of the transferred assets or liabilities is determinable. As a result, the pro forma balance sheet for a common control transaction primarily includes pro forma adjustments to capital accounts.

As discussed in Section 5.3.1, pro forma condensed income statements are required for all historical financial statement periods presented in a registrant's filing when the pro forma information reflects a reorganization of entities under common control. If the consideration consists of equity (e.g., common stock), there generally would be adjustments to the weighted average shares outstanding for the issuance of shares when computing EPS. If the consideration is cash, the excess of the carrying amount of the transferred assets and liabilities should be treated as a dividend in the pro forma balance sheet. Revenues and expenses of the entities (after eliminating intercompany transactions) are combined for all periods presented during which they were under common control.

Illustration 6-21: Reorganization of entities under common control

A private equity firm enters into a transaction to reorganize and merge two companies it controls, ABC Co. and XYZ Co. Under the agreement, ABC Co. is the surviving entity, and all of the outstanding interests in XYZ Co. are exchanged for 1 million shares of ABC Co. common stock. The following unaudited pro forma combined balance sheet and statement of operations were derived from historical financial statements of ABC Co. and XYZ Co (in thousands, except share amounts).

Unaudited Pro Forma Condensed Combined Financial Information

As of and for the year ended 31 December 20X4

	ABC Co. Historical	XYZ Co. Historical	Pro Forma Adjustments Share Exchange		Pro Forma Combined
[All other financial statement line items excluded for presentation purposes]					
Common Stock, $.05 par value	$ 155	$ 150	$ (100)	(a)	$ 205
Additional Paid in Capital	22,300	5,800	100	(a)	28,200
Accumulated deficit	(3,900)	(5,200)	–		(9,100)
Total liabilities and shareholders' deficit	18,555	750	–		19,305
[All other financial statement line items excluded for presentation purposes]					
Net income	$ 1,620	$ 500	$ 160	(b)	$ 2,280
Net income per common share (basic and diluted)	$ 0.52	$ 0.17			$ 0.56
Weighted average shares outstanding (basic and diluted)	3,100,000	3,000,000	(2,000,000)		4,100,000

[Only one year shown for presentation purposes]

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) Represents an adjustment to increase the common stock of the surviving entity by the par value of the 1 million shares issued in connection with the transaction and to eliminate the par value of the common stock of XYZ Co. acquired, as well as to increase additional paid-in capital for the net difference.

(b) In connection with the transaction, a new management services agreement was entered into by the combined entity that replaces separate agreements that each entity had with a third party for certain management services. This represents adjustments to reduce selling, general and administrative expenses to give effect to cost savings under the terms of the new agreement, net of the related income tax effect.

6.2.4 Acquisition of equity method investees

Acquiring an interest in a business accounted for under the equity method could trigger the requirement to provide pro forma financial information if it represents a significant acquisition. While separate historical financial statements of the investee would be included in the registrant's filing as required by Rule 3-05 of Regulation S-X, a separate column presenting the historical results of the investee in the pro forma information is not necessary. Instead, companies may include an adjustment to the pro forma income statement based upon the pro rata share of the historical earnings adjusted for any basis differences. The computation of the pro rata share of the equity earnings should be disclosed in the notes to the pro forma financial information.

A registrant may elect the fair value option to account for the equity method investment under ASC 825. The SEC staff has said that full pro forma financial information is not required in that situation (similar to the acquisition of financial assets). However, the SEC staff expects the registrant to include an explanation of how the application of the fair value option for the equity method investment will affect the results of operations and the balance sheet in future periods.[18]

Illustration 6-22: Acquisition of an equity method investment

A calendar-year registrant acquires a 49% equity interest in a company on 2 June 20X5.

The registrant might provide the following pro forma financial information and disclosures related to the acquisition (in millions):

Unaudited Pro Forma Condensed Consolidated Financial Information

As of and for the six months ended 31 March 20X5

	Registrant Historical	Pro Forma Adjustments	Notes	Pro Forma Combined
Cash and equivalents	$ 1,400	$ (500)	(a)	$ 900
Investment in unconsolidated affiliates	35	500	(a)	535
Equity in earnings of unconsolidated affiliates	–	10	(b)	10

[18] SEC staff's Financial Reporting Manual Section 3110.1.

For the year ended 31 December 20X4

Equity in earnings of unconsolidated affiliates	–	25	(b)	25

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) The use of funds for the acquisition of the 49% interest in Target consists of consideration of $495 million and $5 million of acquisition costs.

(b) This adjustment reflects 49% of Target's net income of $20.4 million and $51.1 million for the three months ended 31 March 20X5 and the year ended 31 December 20X5, respectively.

6.2.5 Exchange transactions

In an exchange transaction, the registrant and another party contribute businesses to a joint venture (e.g., Newco) in exchange for an equity interest. To determine whether pro forma financial information is required, the registrant should measure the significance of the business being disposed (i.e., contributed by the registrant) and separately measure the significance of the business being acquired (i.e., contributed by the other party). The pro forma presentation should show the effect of the disposition and the acquisition in separate columns. For an example of a pro forma presentation of a disposition, see Section 6.2.2; for an example of a pro forma presentation of an acquisition, see the Appendix.

6.2.6 Emergence from bankruptcy

Pro forma financial information in connection with a company's emergence from bankruptcy may be material to investors. Pro forma adjustments would likely need to reflect fair value adjustments for assets and liabilities if the criteria for fresh start accounting under ASC 852 are met. Other examples of pro forma adjustments may include giving effect to a reorganization plan filed with and confirmed by a bankruptcy court showing adjustments for allowed claims, exit financing facilities and the recapitalization of a company emerging from bankruptcy.

A registrant typically incurs various costs related to the bankruptcy that are reflected in its historical financial statements. When preparing the pro forma income statement a registrant should make adjustments to eliminate nonrecurring costs that are directly related to the bankruptcy and incremental to the registrant's continuing operations. For example, pro forma adjustments would remove legal and professional fees directly related to legal representation during bankruptcy, fees associated with handling and settling claims and preparing necessary documentation for the court, changes in allowed claims as compared to previously recorded amounts, and debt issuance costs associated with debtor in possession financing. However, such amounts should be reflected in historical liabilities and retained earnings in the pro forma balance sheet.

The SEC staff does not believe the pro forma adjustments should include the reversal of previously recognized impairment charges because they are unrelated to resolution of the bankruptcy proceedings. Even though the impaired assets would have been stated at fair value if the registrant had adopted fresh-start accounting at the beginning of the reporting period and, presumably, impairment charges likely would not have been recorded related to the new accounting basis for the assets, historical impairment charges are not directly related to the bankruptcy or emergence from bankruptcy.

Illustration 6-23: Emergence from bankruptcy

ABC Co. provided the following pro forma financial information to give effect to its reorganization plan confirmed by a US Bankruptcy Court on 25 March 20X5. The plan provides for the payment of allowed claims, exit financing and recapitalization through the cancellation of the company's existing stock and issuance of new common stock. For purposes of the illustration, ABC Co. has met the criteria for fresh start accounting under ASC 852 (in millions).

Unaudited Pro Forma Condensed Consolidated Balance Sheet

As of 31 December 20X4

	Registrant Historical	Claims Settlements and Financing Adjustments		Fresh start and Other Adjustments		Pro Forma Combined
Cash and cash equivalents	$ 600	$ (100)	(a)	$ –		$ 1,050
		550	(b)			
Accounts receivable, net	450	–		–		450
Inventories	2,000	–		200	(d)	2,200
Property and equipment, net	2,500	–		500	(d)	3,000
Intangible assets, net	1,500	–		400	(d)	1,900
Goodwill	4,000	–		350	(d)	4,350
Other assets	1,200	–				1,200
Total assets	12,250	450		1,450		14,150
Accounts payable	500	–				500
Notes payable	1,600	–		1,700	(d)	3,300
Accrued liabilities	800	–		100	(d)	900
Long-term debt / Exit financing	2,000	550	(b)	–		2,550
Other liabilities	1,300	–		–		1,300
Liabilities subject to compromise	9,300	(9,300)	(a)	–		–
Total Liabilities	15,500	(8,750)		1,800		8,550
Common Stock	600	800	(c)	(600)	(e)	800
Additional Paid-in Capital	2,150	4,800	(c)	(2,150)	(e)	4,800
Retained earnings (deficit)	(6,000)	3,600	(a)	2,400	(e)	–
Total equity (deficit)	(3,250)	9,200		(350)		5,600
Total liabilities and equity (deficit)	12,250	450		1,450		14,150

Unaudited Pro Forma Condensed Consolidated Statement of Operations

For the year ended 31 December 20X4

	Registrant Historical	Claims Settlements and Financing Adjustments		Fresh start and Other Adjustments		Pro Forma Combined
Interest expense	—	55	(f)	—		55
Reorganization items, net	1,500	—		(1,500)	(g)	—

[All other financial statement line items excluded for purposes of illustration]

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) As part of the plan of reorganization, the bankruptcy court approved the settlement of certain allowed claims, reported as liabilities subject to compromise (LSTC) in our historical condensed consolidated balance sheet. The LSTC was satisfied by paying $100 in cash and issuing new common stock in the reorganized entity. As a result, a gain of $3,600 [$9,300 − ($100 + $800 + $4,800) was recognized on the settlement of liabilities subject to compromise.

(b) This adjustment reflects the drawdown on a senior secured term loan. The loan and cash proceeds are reflected net of other financing costs. The loan is classified as a long-term liability based on its terms.

(c) Represents new common stock and associated paid-in capital issued to creditors.

(d) Represents adjustments to assets and liabilities as a result of the application of the guidance in ASC 805.

(e) These adjustments reflect the elimination of pre-emergence from bankruptcy common stock and other capital accounts and to reset retained earnings to zero.

(f) The Bankruptcy Court had issued a stay order relating to our debt agreements during the bankruptcy process resulting in no interest expense being recorded in our statement of operations in accordance with ASC 852. This adjustment reflects interest expense on new exit financing based on contractual interest rates and commitment fees specified and amortization of original issue discount.

(g) Reorganization items, net represent charges for trustee and professional fees incurred subsequent to the bankruptcy filing as a direct result of the filing of the Chapter 11 case and included in our historical statement of operations for the year ended 31 December 20X4. This adjustment removes the effect of charges related to the bankruptcy process that will not have a continuing effect on the reorganized entity.

6.2.7 New or modified contractual arrangements

The buyer may enter into new contractual arrangements or modify existing agreements with the acquiree (in addition to new compensation arrangements with its management, which are discussed in Section 6.2.1.15). The SEC staff believes that the effects of major new distribution, cost-sharing or management agreements, and compensation or benefit plans may be reflected in pro forma financial information only if those amounts are factually supportable, directly attributable to the transaction and expected to have a continuing impact on the statement of operations.[19]

In connection with a spin-off of a subsidiary, a formal management agreement that provides for payments intended to cover administrative costs incurred by the parent on behalf of the subsidiary being spun-off may be terminated or modified. If a new agreement is executed with different terms, pro forma adjustments for the contractually modified fee may be made. If the old agreement is terminated because the subsidiary or its former parent will now perform the activities covered by the previous management agreement, an adjustment to eliminate historical management fees and recognize expected standalone costs generally would not be factually supportable.

Excerpt from SEC staff guidance

Staff Accounting Bulletin Topic 1: Financial Statements

B.2 Pro Forma Financial Statements and Earnings Per Share (tax or other cost sharing agreements that will be terminated or revised)

Question: What disclosure should be made if the registrant's historical financial statements are not indicative of the ongoing entity (e.g., tax or other cost sharing agreements will be terminated or revised)?

Interpretive Response: The registration statement should include pro forma financial information that is in accordance with Article 11 of Regulation S-X and reflects the impact of terminated or revised cost sharing agreements and other significant changes.

6.2.8 Other pro forma adjustments

6.2.8.1 Income tax effects

The income tax effects of pro forma adjustments should be calculated based on the statutory rate in effect during the periods for which the pro forma income statement is being presented. If taxes are calculated using a rate other than the statutory rate in effect or if there are unusual effects of other aspects of tax accounting (e.g., loss carryforwards), the registrant should provide an explanation in a note to the pro forma financial information.

See Section 6.2.1.13 for additional guidance on other aspects of tax accounting.

6.2.8.2 Costs of being a public company

Pro forma adjustments must be directly attributable to the transaction reflected in the pro forma financial information. For example, the SEC staff has said that the additional costs a company expects to incur as a public company are generally not attributable to transactions (e.g., business combinations) for which a company might provide pro forma financial information in an IPO registration statement. The SEC staff believes these costs would be essentially projections and would not be appropriate pro forma adjustments.

[19] SEC staff's Financial Reporting Manual Section 3280.

6.2.8.3 Pro forma effects on measures of performance or liquidity

The use of non-GAAP financial measures in SEC filings must comply with Item 10(e) of Regulation S-K. When a company presents a non-GAAP financial measure in an SEC filing it must (1) present, with equal or greater prominence, the most directly comparable financial measure calculated and presented in accordance with GAAP and (2) reconcile the non-GAAP financial measure, by schedule or other clearly understandable format, to the most directly comparable GAAP measure.

Non-GAAP financial measures may not be presented on the face of any pro forma financial information required to be disclosed under Article 11 of Regulation S-X. The following is an example of non-GAAP measures used in pro forma financial information:

Illustration 6-24: Pro forma non-GAAP measures

A company includes the following pro forma non-GAAP measures in connection with an acquisition after the unaudited pro forma balance sheet, statement of operations and related notes.

[The illustration below excludes language describing the limitations of using non-GAAP measures and a statement describing why management believes the presentation of non-GAAP measures provides useful information to investors.]

A reconciliation of pro forma EBITDA to pro forma Net Income (loss) determined in accordance with GAAP is provided below (in millions):

Pro forma combined EBITDA

For the year ended 31 December 20X4

	Historical		Pro Forma	Pro Forma
	Registrant	Target XYZ	Adjustments	Combined
Net Income (loss)	$ 180	$ 40	$ 7	$ 227
Interest expense, net	120	110	10	240
Provision (benefit) for income taxes	115	24	3	142
Depreciation and amortization	325	90	9	424
EBITDA	740	264	29	1,033

6.2.8.4 Use of proceeds

Under Item 504 of Regulation S-K, the registrant must disclose in the registration statement how it intends to use the net proceeds from its offering of securities and how much of the proceeds it intends to use for each purpose. If the registrant has no current plan for the proceeds (or for a significant portion of the proceeds), it must state this and discuss the principal reasons for the offering.

Registrants may reflect the receipt or application of offering proceeds in pro forma financial statements, (1) up to the amount of a firm commitment from an underwriter (2) up to the minimum amount in a best-efforts minimum/maximum offering or (3) the offering amount in a best-efforts all-or-none offering. Pro forma financial information also may reflect the receipt or application of offering proceeds in certain savings and loan conversions. In addition, the application of proceeds should be limited to the transactions or events being reflected in the pro forma financial information being presented.

In capitalization tables, registrants also can (1) present both the minimum and the maximum amounts in the capitalization table in a minimum/maximum offering and (2) include the proceeds to the extent exercise of outstanding warrants in a securities offering or a rights offering is likely due to the current share price.

Illustration 6-25: Use of proceeds

In this example, the registrant does not have a specific corporate purpose for the use of the proceeds in a firm commitment offering. The registrant might make the following disclosures:

Use of proceeds:

We estimate that the net proceeds from this offering of shares of our common stock will be approximately $139.2 million, based on an assumed public offering price of $39 per share, which is the last reported sale price of our common stock on the NASDAQ Global Market on 15 April 20X4, after deducting underwriting discounts and commissions and estimated offering expenses payable by us.

[The underwriters' option to purchase additional shares from the company and a sensitivity analysis in the assumed public offering price are excluded for this illustration]

We intend to use the net proceeds received by us from this offering for general corporate purposes.

Capitalization:

The table below sets forth our long-term debt and capitalization as of 31 December 20X4, as follows (in thousands except per share information):

- On an actual basis as of 31 December 20X4
- On an as adjusted basis to reflect our receipt of net proceeds from the sale of 3,800,000 shares of common stock in the offering at the assumed public offering price of $39 per share after deducting underwriting discounts and commissions payable by us.

	As of 31 December 20X4	
	Actual	As adjusted
Long-term debt	$ 1,000,000	$ 1,000,000
Stockholders' equity		
Common stock, par value $0.001 per share; 200,000 shares authorized; 22,170 shares issued and outstanding, actual and 25,970 shares issued and outstanding, as adjusted	22	26
Additional paid-in capital	258,400	397,600
Accumulated other comprehensive loss	(7)	(7)
Accumulated deficit	(117,409)	(117,409)
Total stockholders' equity	141,006	280,210
Total capitalization	1,141,006	1,280,210

7 Other pro forma considerations

This section summarizes other requirements for pro forma financial information and financial forecasts. Additional pro forma disclosures may be permitted or required for specific transactions or in registration statements, such as:

- Pro forma EPS disclosures on the face of the historical financial statements in IPO registration statements
- Pro forma book value per share
- Pro forma ratio of earnings to fixed charges
- Pro forma MD&A disclosures

In addition, registrants may determine that it is more appropriate to present a financial forecast in lieu of a pro forma income statement.

7.1 IPO considerations

Article 11 of Regulation S-X requires pro forma financial information for events or transactions that are material to investors. As a result, the SEC staff often requires companies to present additional pro forma disclosures in or alongside the historical financial statements in their IPO registration statements.

7.1.1 Planned distributions not reflected in the historical balance sheet

Excerpt from SEC staff interpretations

Staff Accounting Bulletins

Topic 1B.3, Other matters

Question: What is the staff's position with respect to dividends declared by the subsidiary subsequent to the balance sheet date?

Interpretive Response: The staff believes that such dividends either be given retroactive effect in the balance sheet with appropriate footnote disclosure, or reflected in a pro forma balance sheet. In addition, when the dividends are to be paid from the proceeds of the offering, the staff believes it is appropriate to include pro forma per share data (for the latest year and interim period only) giving effect to the number of shares whose proceeds were to be used to pay the dividend. A similar presentation is appropriate when dividends exceed earnings in the current year, even though the stated use of proceeds is other than for the payment of dividends. In these situations, pro forma per share data should give effect to the increase in the number of shares which, when multiplied by the offering price, would be sufficient to replace the capital in excess of earnings being withdrawn.

In accordance with SAB Topic 1.B.3, pro forma disclosures may be required when dividends are declared or a distribution to prior owners, promoters and/or parents is planned after the date of the latest balance sheet presented. The SEC staff believes that dividends declared by a subsidiary after the balance sheet date should be reflected in a pro forma balance sheet in the IPO filing.[20] If a planned distribution is not reflected in the latest balance sheet but would be significant relative to the reported equity, a pro forma

[20] SEC staff's Financial Reporting Manual Section 3420.

balance sheet reflecting accrual of the subsequent distribution (but not giving effect to the offering proceeds) should be presented alongside the historical balance sheet in the filing, regardless of whether the distribution has been declared or is to be paid from proceeds.

7.1.2 Distributions in excess of earnings

The SEC staff also provided its views in SAB Topic 1.B.3 about the presentation of pro forma EPS when dividends paid or planned exceed current earnings. It is important for registrants to consider the applicability of this guidance when calculating pro forma EPS even when the stated use of proceeds in the capitalization table of a registration statement does not include payment of such dividends. The pro forma presentation requirements of this SAB Topic are applicable to dividends paid at or prior to closing of an IPO that are greater than the current year's earnings. The SEC staff assumes that offering proceeds will be used to replenish capital used to pay dividends within 12 months of the offering if those dividends exceed earnings during the prior 12 months.

The purpose of considering these dividends in pro forma EPS is to include the effect of common shares for which a registrant would have to raise proceeds to pay the portion of dividends exceeding current year's net income, which has been interpreted to mean the most recent 12 months. The shares that are assumed issued are added to historical shares outstanding in the denominator of the pro forma EPS calculation. The number of shares added to historical shares outstanding in the denominator should not exceed the total number of shares issued in the offering.

In these cases, pro forma EPS should be presented only for the most recent annual and interim periods, and the staff frequently requests presentation on the face of the statement of operations in addition to the historical EPS measures for these periods (e.g., in separate line items below historical EPS). The pro forma EPS measures should be labeled unaudited.

The following illustration is an example pro forma EPS calculation that includes the effect of additional shares whose proceeds were assumed to be used to fund dividends.

Illustration 7-1: Pro forma EPS — dividends in excess of current-year earnings

Company A is planning an initial public offering of its common stock. Prior to its IPO, Company A had 100,000 shares of common stock outstanding. Company A will sell 800,000 shares in the IPO for \$6.25 per share. Proceeds will total \$5 million before underwriting discounts and other expenses. Company A's net income for the previous 12 months was \$1 million.

Scenario 1:

Company A will use the proceeds from its IPO together with the funds provided by a bank line of credit to pay a \$3.5 million dividend to its shareholders at the time of closing.

In this scenario, the dividend of \$3.5 million exceeds the most recent year's net income of \$1 million but is not greater than total offering proceeds of \$5 million. The \$2.5 million (\$3.5 million dividend, less \$1 million net income) represents the amount of the dividend in excess of current-year earnings, which is deemed to be paid from the offering proceeds. Because this excess does not exceed total offering proceeds, only a portion of the total 800,000 IPO shares would be added to the historical 100,000 shares in the pro forma EPS denominator. To pay the excess \$2.5 million dividend, Company A would have to issue 400,000 shares (\$2.5 million excess dividend, divided by the offering price per share of \$6.25). Therefore, the pro forma EPS denominator would be calculated as follows:

Pre-existing (historical) weighted average shares outstanding	100,000
IPO shares required to fund dividend in excess of earnings	400,000
Pro forma shares	500,000

Scenario 2:

Company A will use the proceeds from its IPO together with the funds provided by a bank line of credit to pay a $15 million dividend to existing shareholders at the time of closing.

In this scenario, the dividend that Company A will pay shareholders at the closing date of the IPO ($15 million) exceeds Company A's net income for the previous 12 months ($1 million). Therefore, a portion of the dividend is deemed paid from the proceeds of the IPO. Since the amount of the dividend in excess of Company A's net income for the previous 12 months ($14 million) exceeds the gross proceeds of the IPO ($5 million), Company A should include all 800,000 of the shares offered in the IPO in the denominator of the pro forma EPS calculation. Therefore, the pro forma EPS denominator would be calculated as follows:

Pre-existing (historical) weighted average shares outstanding	100,000
Total IPO shares	800,000
Pro forma shares	900,000

To present a transparent picture for investors, the numerator of the pro forma EPS computation in Scenario 2 also should be adjusted to reflect the additional interest expense (net of tax) assumed incurred to finance the portion of the dividend that exceeds both the gross proceeds from the equity offering and the previous 12 months' earnings ($9 million in this example: $15 million dividend less $1 million in earnings and $5 million in IPO proceeds).

7.1.3 Changes in tax status

Many private companies are organized as nontaxable entities (e.g., S-corporations, limited-liability corporations, partnerships) to minimize the tax burden on the equity owners. However, prior to consummation of an IPO, these companies often convert to C-corporations, which are taxable entities. In these cases, the SEC staff expects IPO registrants to present pro forma income tax and pro forma EPS on the face of the historical statement of operations.[21] Pro forma income tax should be calculated using statutory tax rates that were in effect in prior periods. Presentation is generally limited to the most recent annual and interim period included in the IPO registration statement. However, if the pro forma adjustments relate to only income taxes (i.e., the IPO registration statement does not include any other pro forma information for other events or transactions), the SEC staff encourages registrants to present pro forma income tax and pro forma EPS for all periods included in the historical financial statements.

If a registrant elects to present pro forma information for all periods, as noted above, pro forma income tax and EPS measures should continue to be presented in SEC filings made after the IPO.

Undistributed earnings (or losses) of a former Subchapter S-corporation or partnership should be reclassified to paid-in capital in the pro forma financial statements. This presentation assumes a constructive distribution to (contribution by) the owners or partners followed by a capital contribution (distribution).

Subchapter S corporations or partnerships that pay distributions to promoter/owners at the closing or effective date with proceeds of the offering (rather than out of current earnings) should consider the pro forma EPS presentation described in Section 7.1.2 above.

[21] SEC staff's Financial Reporting Manual Section 3410.

7.1.4 Other changes in capitalization

Pro forma financial information may be required if reorganizations, unusual asset exchanges, debt restructurings, debt refinancing or other changes in capitalization (e.g., redeemable preferred stock, debt convertible to common stock) occur at the effective date or the close of an offering, including an IPO. Generally, the historical balance sheet and statement of operations (including EPS) should not be revised to reflect modifications of the terms of outstanding securities that become effective after the latest balance sheet date, although pro forma data may be necessary to reflect these transactions.

If terms of outstanding equity securities will change subsequent to the date of the latest balance sheet and the new terms result in a material change to equity, or if redemption of a material amount of equity securities will occur in conjunction with the offering, the filing should include a pro forma balance sheet (excluding effects of offering proceeds) presented alongside the historical balance sheet giving effect to the change in capitalization.

If the conversion of outstanding securities or other changes in capitalization will occur subsequent to the latest balance sheet date and the conversion or change would materially affect earnings per share (excluding effects of the offering), pro forma EPS for the latest year and interim period also should be presented giving effect to the conversion or other changes in capitalization. This pro forma EPS calculation should give effect only to the assumed conversion of outstanding securities and not the offering. Pro forma EPS reflecting the assumed conversions generally is presented on the face of the historical financial statements included in the registration statement in addition to historical EPS.

7.1.5 Example — Disclosure of pro forma financial information in an IPO

Illustration 7-2: Pro forma financial information in IPO filing

Company A has decided to undertake an IPO of its common stock and expects to file its Form S-1 registration statement on 1 April 20X5. The key facts include:

- Prior to its IPO, Company A has 1 million shares of issued and outstanding common stock. In addition, Company A has outstanding preferred stock that is contingently convertible upon an IPO.
- Company A expects to sell 8 million shares in the IPO for $15 per share. The offering will yield total proceeds of $120 million before underwriting discounts and other expenses.
- In connection with the IPO, Company A will convert its preferred stock into 1 million shares of common stock.
- On 6 January 20X5, Company A declared and paid a dividend of $55 million to its shareholders from cash on hand.
- Company A's net income for the previous 12 months was $10 million. Accordingly, $45 million of IPO proceeds (or 3 million shares) must be assumed to fund the dividend.

In accordance with SAB Topic 1.B.3, Company A reflected adjustments to its pro forma balance sheet and pro forma earnings-per-share calculations presented on the face of its historical financial statements.

The following excerpts show possible illustrations and disclosures of the pro forma balance sheet and pro forma earnings per share:

Balance Sheets (in 000's)

	Pro Forma 31 December 20X4	Historical 31 December 20X4
[Several financial statement line items excluded for presentation purposes]		
Liabilities and shareholders' equity		
Accounts payable	45,000	45,000
Dividend payable	55,000	–
Long-term debt	25,000	25,000
Other noncurrent liabilities	10,000	10,000
Total liabilities	135,000	80,000
Shareholders' equity		
Convertible preferred shares	–	10,000
Common shares, $0.01 par value	20	10
Additional paid-in capital	19,980	9,990
Retained earnings	10,000	65,000
Total shareholders' equity	30,000	85,000
Total liabilities and shareholders' equity	$ 165,000	$ 165,000

Statements of Operations (in 000's)

	Year Ended 31 December 20X4
[Several financial statement line items excluded for presentation purposes]	
Net income	10,000
Preferred stock dividends	(1,000)
Net income to common shareholders	$ 9,000
Net earnings per common share, basic and diluted	$ 9.00
Basic and diluted weighted average common shares outstanding	1,000
Pro forma net earnings per common share, basic and diluted	$ 2.00
Basic and diluted weighted average common shares outstanding used in computing pro forma net earnings per share	5,000

XX. Supplemental Pro forma Balance Sheet and Net Income Per Share (Unaudited)

The unaudited pro forma balance sheet and pro forma basic and diluted net income per share reflect: (1) the accrual of the $55 million dividend that was declared and paid on 6 January 20X5 and (2) the expected conversion of all outstanding preferred shares with a historical value of $10 million to 1 million common shares in connection with the IPO.

The dividend payment in January 20X5 was made in contemplation of the IPO offering. Pro forma net income per share gives effect to 3 million additional common shares issued in the IPO that would be necessary to fund the excess of the dividend payment over the current-period earnings of $10 million. The additional common shares were calculated assuming an initial public offering price of $15.00 per share (the midpoint of the IPO range).

The following table sets forth the computation of pro forma basic and diluted earnings per share for the year ended 31 December 20X4:

Net income to common shareholders	$	9,000
Pro forma adjustment to remove preferred dividends		1,000
Net income used to compute pro forma net earnings per share	$	10,000
Basic and diluted weighted average common shares outstanding		1,000
Pro forma adjustment to reflect conversion of preferred shares		1,000
Pro forma adjustment to reflect common shares sold in the IPO to fund dividend payments in excess of current earnings		3,000
Basic and diluted weighted average common shares outstanding used in computing pro forma net earnings per share		5,000
Pro forma net earnings per common share, basic and diluted	$	2.00

7.1.6 Pro forma EPS presentation in SEC filings after IPO

Pro forma EPS are generally not required in financial statements issued after an IPO except when there is a change in tax status as discussed in Section 7.1.3.

Illustration 7-3: Subsequent filing after IPO

A calendar-year registrant's IPO registration statement on Form S-1 included pro forma EPS information to reflect the conversion of preferred stock to common shares for the most recent interim and annual periods included in the registration statement (the six months ended 30 June 20X5 and the fiscal year ended 31 December 20X4, respectively).

If the registration statement has an effective date of 2 October 20X5, the registrant would not present the pro forma EPS information in its third quarter 20X5 financial statements filed on Form 10-Q even though the pre-IPO capital structure was still in place as of 30 September 20X5.

7.2 Financial forecasts

Excerpt from SEC Rules and Regulations

Regulation S-X, Article 11 Pro Forma Financial Information

Rule 11-03, Presentation of financial forecast

(1) A financial forecast may be filed in lieu of the pro forma condensed statements of income required by Regulation S-X Rule 11-02(b)(1).

a. The financial forecast shall cover a period of at least 12 months from the latest of (i) the most recent balance sheet included in the filing or (ii) the consummation date or estimated consummation date of the transaction.

b. The forecasted statement of income shall be presented in the same degree of detail as the pro forma condensed statement of income required by Regulation S-X Rule 11-02(b)(3).

c. Assumptions particularly relevant to the transaction and effects thereof should be clearly set forth.

d. Historical condensed financial information of the registrant and the business acquired or to be acquired, if any, shall be presented for at least a recent 12 month period in parallel columns with the financial forecast.

(2) Such financial forecast shall be presented in accordance with the guidelines established by the American Institute of Certified Public Accountants.

(3) Forecasted earnings per share data shall be substituted for pro forma per share data.

(4) This rule does not permit the filing of a financial forecast in lieu of pro forma information required by generally accepted accounting principles.

A financial forecast presents a company's expected results of operations. It may be expressed in specific monetary amounts as a single-point estimate or as a range. A financial forecast differs from a financial projection, which presents prospective financial information based on one or more hypothetical assumptions (i.e., "what would happen if" estimates).

Rule 11-03 of Regulation S-X permits companies to present a financial forecast in lieu of a pro forma condensed income statement. Electing this option does not eliminate the requirements to present a pro forma balance sheet. In the SEC staff's view, the pro forma balance sheet is necessary to reflect the effect of the transaction on the financial position of the registrant. In addition, companies cannot substitute financial forecasts for pro forma disclosures required under US GAAP (e.g., pro forma disclosures required by ASC 805, *Business Combinations*).

The use of a forecast in certain circumstances may be more relevant than a pro forma condensed income statement. In practice, very few forecasts are filed in lieu of pro forma income statements, likely due to concerns about additional legal liability

Illustration 7-4: Forecast in lieu of pro forma income statement

A registrant acquires a significant oil and gas property from ABC Company on 31 March 20X5 that requires audited financial statements under Rule 3-05 of Regulation S-X for the year ended 31 December 20X4. The property represents only a portion of the assets of ABC Company and is not a segment, division or separate legal subsidiary of ABC Company. In addition, it would be impracticable to prepare full financial statements of the oil and gas property because ABC Company did not maintain distinct and separate accounts of the property. Therefore, the registrant determines that it is appropriate to provide abbreviated financial statements of the oil and gas property (e.g., statements of revenue and direct expenses and statements of assets acquired and liabilities assumed) to satisfy the Rule 3-05 requirements.

When preparing the pro forma financial information for the significant acquisition of the gas and oil property as of and for the year ended 31 December 20X4, the registrant determines that a forecast about post-acquisition results of operations would be more meaningful than a pro forma statement of operations. The historical abbreviated financial statements of the acquired property are not indicative of the financial condition or results of operations going forward because they omit various operating expenses. If the forecast complies with the requirements of Rule 11-03 of Regulation S-X, the registrant may omit a pro forma income statement but would continue to provide a pro forma balance sheet as of 31 December 20X4. The forecast must cover at least the twelve months ending 31 March 20X6.

7.2.1 Presentation and disclosure requirements

Forecasts must follow presentation guidelines issued in the AICPA's Guide for Prospective Financial Statements and S-X Rule 11-03 and comply with the guidelines for projections in S-K Item 10, including the following:

- The financial forecast must cover a period of at least 12 months from the later of the latest balance sheet included in the filing or the actual or planned consummation date of the transaction.
- The financial forecast should be presented in the same level of detail as would be required for a pro forma condensed income statement, substituting forecasted EPS for pro forma EPS.
- The determination and effects of assumptions should be reasonable and clearly disclosed. Persuasive evidence is necessary as support for assumptions including market surveys, historical operating results, internal analyses and other third-party reports.
- Historical information of the registrant and business to be acquired (if applicable) should be presented for a recent 12-month period in parallel columns with the forecast.

7.3 Rollup transactions

Excerpt from SEC rules and regulations

Regulation S-K, Subpart 900 — Roll-Up Transactions

Item 914, Pro forma financial statements; selected financial data

(a) In addition to the information required by Item 301 of Regulation S-K, Selected Financial Data, and Item 302 of Regulation S-K, Supplementary Financial Information, for each partnership proposed to be included in a roll-up transaction provide: Ratio of earnings to fixed charges, cash and cash equivalents, total assets at book value, total assets at the value assigned for purposes of the roll-up transaction (if applicable), total liabilities, general and limited partners' equity, net increase (decrease) in cash and cash equivalents, net cash provided by operating activities, distributions; and per unit data for net income (loss), book value, value assigned for purposes of the roll-up transaction (if applicable), and distributions (separately identifying distributions that represent a return of capital). This information should be provided for the same period(s) for which Selected Financial Data and Supplementary Financial Information are required to be provided. Additional or other information should be provided if material to an understanding of each partnership proposed to be included in a roll-up transaction.

(b) Provide pro forma financial information (including oil and gas reserves and cash flow disclosure, if appropriate), assuming:

(1) All partnerships participate in the roll-up transaction; and

(2) Participation in a roll-up transaction of those partnerships that on a combined basis have the lowest combined net cash provided by operating activities for the last fiscal year of such partnerships, provided participation by such partnerships satisfies all conditions to consummation of the roll-up transaction. If the combination of all partnerships proposed to be included in a roll-up transaction results in such lowest combined net cash provided by operating activities, this shall be noted and no separate pro forma financial statements are required.

(c) The pro forma financial statements required by paragraph (b) of this Item shall disclose the effect of the roll-up transaction on the successor's:

(1) Balance sheet as of the later of the end of the most recent fiscal year or the latest interim period;

(2) Statement of income (with separate line items to reflect income (loss) excluding and including the roll-up expenses and payments), earnings per share amounts, and ratio of earnings to fixed charges for the most recent fiscal year and the latest interim period;

(3) Statement of cash flows for the most recent fiscal year and the latest interim period; and

(4) Book value per share as of the later of the end of the most recent fiscal year or the latest interim period.

A roll-up transaction involves the combination or reorganization of one or more partnerships, directly or indirectly, in which some or all of the investors in any of the partnerships will receive new securities, or securities in another entity. However, not all combination or reorganization transactions involving partnership interests will be subject to these roll-up disclosure requirements, and careful consideration and analysis should be performed when considering whether a transaction meets the definition of a roll-up transaction under Item 901(c) of Regulation S-K.

A registrant must disclose the following pro forma financial information showing the effect of a proposed roll-up transaction on the successor entity:

- Balance sheet as of the later of the end of the most recent fiscal year or latest interim period
- Statements of income for the most recent fiscal year and the latest interim period with separate line items to reflect income (loss) excluding and including roll-up expenses and payments, earnings-per-share amounts and ratio of earnings to fixed charges
- Statement of cash flows for the most recent fiscal year and the latest interim period
- Book value per share as of the later of the end of the most recent fiscal year or the latest interim period
- Pro forma oil and gas reserve data, if applicable

This information should be prepared assuming (1) all partnerships participate and (2) participation is limited only to those partnerships with the lowest combined net cash provided by operating activities for the last fiscal year of such partnerships, which would still satisfy the minimum participation requirements specified in the proposed transaction.

7.4 Additional Form S-4 and proxy statement pro forma requirements

Excerpt from SEC rules and regulations

Form S-4, Registration Statement Under the Securities Act of 1933

Part I, Information Required in the Prospectus, Item 3. Risk Factors, Ratio of Earnings to Fixed Charges and Other Information

Provide in the forepart of the prospectus a summary containing the information required by Item 503 of Regulation S-K and the following: […]

(f) In comparative columnar form, historical and pro forma per share data of the registrant and historical and equivalent pro forma per share data of the company being acquired for the following items:

(1) book value per share as of the date financial data is presented pursuant to Item 301 of Regulation S-K (selected financial data);

(2) cash dividends declared per share for the periods for which financial data is presented pursuant to Item 301 of Regulation S-K (selected financial data);

(3) income (loss) per share from continuing operations for the periods for which financial data is presented pursuant to Item 301 of Regulation S-K (selected financial data).

Schedule 14A, Information Required in Proxy Statement

ITEM 14. Mergers, consolidations, acquisitions and similar matters

(b) *Transaction information*. Provide the following information for each of the parties to the transaction unless otherwise specified:

10. *Pro forma information*. In a table designed to facilitate comparison, historical and pro forma per share data of the acquiring company and historical and equivalent pro forma per share data of the target company for the following Items:

(i) Book value per share as of the date financial data is presented pursuant to Item 301 of Regulation S-K (selected financial data);

(ii) Cash dividends declared per share for the periods for which financial data is presented pursuant to Item 301 of Regulation S-K (selected financial data);

(iii) Income (loss) per share from continuing operations for the periods for which financial data is presented pursuant to Item 301 of Regulation S-K (selected financial data).

Most state laws require a shareholder vote if a business combination will have a significant effect on either the acquiring company or the target. Companies often file a Form S-4, which is available for registration of securities in connection with business combinations and exchange offers and can "wrap" a proxy statement, or a standalone proxy statement on Schedule 14A to obtain shareholder approval. Item 5 of Form S-4 and Item 14(b)(11) of Schedule 14A require pro forma financial information prepared in accordance with Article 11 of Regulation S-X that gives effect to the merger transactions and may supplement pro forma financial information required for other transactions (e.g., consummated business combinations). Refer to Section 3.2, *Registration statements and proxy statements*, for further discussion about when Article 11 pro forma financial information is required in a Form S-4 or proxy statement and Section 4.2.1, *Pro forma financial information involving multiple transactions*.

In addition, Item 3 of Form S-4 and Item 14(b)(10) of Schedule 14A require the following comparative historical and pro forma per-share data of the acquiring company and historical and *equivalent* pro forma per-share data of the acquired company to be presented in columns:

- Book value
- Cash dividends [Note: The historical and pro forma cash dividends per share of the registrant will typically be the same amount.]
- Income (loss from continuing operations)

For a business combination, this information is required only for the most recent fiscal year and interim period. For a combination between entities under common control, the information is required for the most recent three fiscal years and interim period (except for information with regard to book value that is required only as of the end of the most recent fiscal year and interim period).

Equivalent pro forma per share amounts of the acquired company are calculated by multiplying the respective pro forma per-share amounts of the registrant by the exchange ratio so that those amounts are presented on a pre-exchange per-share basis for the company being acquired. The following illustration provides an example of the pro forma book value per-share disclosures and calculations.

Illustration 7-5: Equivalent pro forma book value per-share data

Registrant Y is filing a Form S-4 to register securities to be issued in the acquisition of Target X. Registrant Y will issue one share of its common stock, with a fair value of $10 per share, for two outstanding Target X common shares (exchange ratio of 50%).

The historical and pro forma balance sheets of Registrant Y and Target X are as follows:

	Registrant Y	Target X	Pro Forma
Common stock, $1 par value	2,000	1,000	2,500
APIC	3,000	500	7,500
Retained earnings	5,000	500	5,000
Shareholders' equity	10,000	2,000	15,000
Common shares outstanding	2,000	1,000	2,500

The net book value per share disclosures would be as follows:

Historical	5.00	[1]	2.00	[1]
Pro forma	6.00	[2]		
Equivalent pro forma			3.00	[3]

Calculation notes:

[1] Total shareholders' equity divided by common shares outstanding. Note that if the financial statements of the registrant or the target include noncontrolling interests, the SEC staff has stated that net book value per share calculations should reflect the shareholders' equity excluding the noncontrolling interest.

[2] Pro forma total shareholders' equity divided by pro forma common shares outstanding

[3] Registrant Y's pro forma net book value per share multiplied by Target X's exchange ratio (50%)

7.5 Tender offers

Excerpt from SEC Rules and Regulations

Regulation S-K, Subpart 1000 — Mergers and Acquisitions (Regulation M-A)

Item 1010, Financial statements

10. Pro forma information. If material, furnish pro forma information disclosing the effect of the transaction on:

    (i) The company's balance sheet as of the date of the most recent balance sheet presented under paragraph (a) of this section;

    (ii) The company's statement of income, earnings per share, and ratio of earnings to fixed charges for the most recent fiscal year and the latest interim period provided under paragraph (a)(2) of this section; and

    (iii) The company's book value per share as of the date of the most recent balance sheet presented under paragraph (a) of this section.

Tender offers involve the offer to buy shares directly from security holders. Tenders may be made by either the issuer of the securities or by a third party. In a tender offer, the offeror may offer cash, securities or a combination of cash and securities. If the consideration consists wholly of or partly of registered securities, the offeror generally will have to register them under the Securities Act of 1933, and financial statement requirements of Form S-4 or F-4 should be followed, unless an exemption from registration is available.

The primary document used to file tender offers is Schedule TO under the Exchange Act. Regulation M-A provides disclosure requirements that apply to a tender offer on Schedule TO. If material, Item 1010(b) of Regulation M-A requires pro forma information disclosing the effects of the transaction on:

- The company's most recent balance sheet
- The company's statement of income, earnings per share and ratio of earnings to fixed charges for the most recent fiscal year and the latest interim period
- The company's book value per share as of the date of the most recent balance sheet

A registrant may need more than one pro forma presentation giving effect to the range of possible results if a proposed transaction may have significantly different results. See Section 4.2.2 for further discussion when a tender offer may involve a range of possible outcomes.

7.6 Pro forma ratio of earnings to fixed charges

Excerpt from SEC rules and regulations

Regulation S-K, Subpart 500 — Registration Statement and Prospectus Provisions

Item 503, Prospectus summary, risk factors, and ratio of earnings to fixed charges

(d) *Ratio of earnings to fixed charges.* If you register debt securities, show a ratio of earnings to fixed charges. If you register preference equity securities, show the ratio of combined fixed charges and preference dividends to earnings. Present the ratio for each of the last five fiscal years and the latest interim period for which financial statements are presented in the document. If you will use the proceeds from the sale of debt or preference securities to repay any of your outstanding debt or to retire other securities and the change in the ratio would be ten percent or greater, you must include a ratio showing the application of the proceeds, commonly referred to as the pro forma ratio.

Instructions to paragraph 503(d):

2. *(B) Pro forma ratio.* You may show the pro forma ratio only for the most recent fiscal year and the latest interim period. Use the net change in interest or dividends from the refinancing to calculate the pro forma ratio.

A pro forma ratio is required in the prospectus when registering debt or preferred stock to be used in a refinancing that affects the historical ratio by 10% or more. For purposes of the ratio, a refinancing is the extinguishment of specific debt with the proceeds of additional debt or the extinguishment of a specific preferred stock with the proceeds of additional preferred stock. The use of proceeds from a preferred stock offering to extinguish debt (or vice versa) is not considered a refinancing for purposes of these rules.

When required, the pro forma ratio may only be presented for the most recent fiscal year and the latest year-to-date period.

7.6.1 Pro forma adjustments

The only permissible adjustments to the historical ratio are those that give effect to the net increase (or decrease) in interest expense or preferred stock dividends resulting from:

- The proposed issuance of new debt (or preferred stock)
- The related retirement of debt (or preferred stock) currently outstanding

If the debt or preferred stock being retired was not outstanding for the entire fiscal year or interim period, the pro forma adjustment should be limited to the net change in interest or preferred dividends for the period it was actually outstanding. In addition, if only a portion of the proceeds will be used to retire outstanding debt or preferred stock, only the interest or preferred dividend attributable to that portion should be included in the pro forma adjustment. Further, if the debt being retired was at a variable rate, the amount of the adjustment should be limited to the actual interest expense on the debt.

Illustration 7-6:	**Adjustments in pro forma ratio of earnings to fixed charges**

A calendar year-end company borrowed $10 million under a short-term line of credit on 1 August 20X4. On 1 May 20X5, the company files a registration statement for $20 million of debentures. The company intends to use half of the proceeds to retire the short-term debt. The pro forma ratio for the year ended 31 December 20X4 would include the following:

- Increase in interest expense assuming that $10 million of the debentures were outstanding for the five months ended 31 December 20X4
- Decrease in interest expense assuming the $10 million short-term credit line was not outstanding for the five months ended 31 December 20X4

Usually, the pro forma ratio is computed before the interest rate on the debt obligation has been finalized (i.e., before the pricing amendment). The ratio is based on an assumed maximum interest rate, offering amount and discount (or minimum premium). When an assumed maximum effective interest rate is used in a preliminary prospectus, the SEC usually will require disclosure of the effect on the pro forma ratio of a difference of 1/8 of 1% from the assumed rate. Ordinarily, this disclosure should be made when a substantial change in the ratio could result from a minor change in the interest rate.

Illustration 7-7:	**Example disclosure — Effect of interest rate assumption**

The ratio has been computed using a maximum assumed interest rate of 10%. A decrease of 1/8 of 1% in the assumed interest rate would increase the pro forma ratio from 1.0 to 1.2.

As a practical matter, when the interest rate is finalized and the pricing amendment is filed, it usually is unnecessary to restate the ratio so long as it has not substantially changed from the ratio computed using the assumed interest rate.

7.6.2 Other pro forma ratios

The preceding discussion relates to the SEC's precise definition of "pro forma" ratios as outlined in Item 503(d) of Regulation S-K. If companies believe another pro forma presentation is necessary for disclosure not to be misleading, this should be discussed in advance with the SEC staff. However, registrants also may provide supplemental pro forma ratios prepared on another basis in their registration statements. If supplemental pro forma ratios are presented, registrants should make certain that they are clearly identified as such.

Illustration 7-8:	**Supplemental pro forma ratio**

A registration statement filed in conjunction with a long-term debt refinancing also includes pro forma financial information relating to a major acquisition. If a supplemental pro forma ratio were provided, it could be disclosed as follows:

Ratio of Earnings to Fixed Charges	**Six Months Ended 30 June**	**Year Ended 31 December**				
	20X5	**20X4**	**20X3**	**20X2**	**20X1**	**20X0**
Actual	2.71	2.51	2.43	2.64	2.10	2.02
Pro Forma (1)	2.25	2.10				
Supplemental Pro Forma (2)	3.67	3.42				

(1) To give effect to the reduction in interest expense due to the refinancing. See Exhibit 12B.

(2) To give effect to both the reduction in interest expense due to the refinancing and the acquisition of XYZ Company as reflected in the pro forma statement of income included in the prospectus. See Exhibit 12C.

7.7 Pro forma MD&A

When a registrant has a material acquisition or applies pushdown accounting, it should consider whether to include a supplemental discussion in MD&A based on pro forma financial information. When determining whether such a discussion is necessary, the registrant should consider all the facts and circumstances of the transaction, the nature of the pro forma adjustments to be made and how meaningful such a discussion would be.

For example, if the application of pushdown accounting in historical financial statements results in separate predecessor and successor periods, the historical financial statements may not be comparable. As a result, the registrant may determine that a discussion based on pro forma financial information would be meaningful to investors.

If a pro forma MD&A discussion is deemed appropriate, the registrant should clearly disclose why management believes the presentation is meaningful, how the presentation was derived and whether there are any risks or limitations associated with the presentation (e.g., the results might not necessarily be indicative of future results). A registrant does not need to include the entire pro forma presentation required by Article 11 when providing supplemental MD&A. The presentation of MD&A based upon the pro forma results should supplement and not replace a discussion based upon the historical results as required by Item 303 of Regulation S-K.

The SEC staff believes that the pro forma discussion should be based on pro forma information prepared in a manner consistent with Article 11 of Regulation S-X unless another presentation (e.g., ASC 805 disclosures) is more appropriate based upon the facts and circumstances. The SEC staff has said that it would not be appropriate to merely combine the pre- and post-transaction results without reflecting all relevant pro forma adjustments required by Article 11.[22]

[22] SEC staff's Financial Reporting Manual Section 9220.8.

8 Auditor involvement

The SEC does not require pro forma financial information to be audited or reported on by an independent registered public accounting firm. However, auditors may perform procedures over pro forma financial information at the request of third parties or to comply with professional auditing standards.

When SEC filings, other than a Securities Act filing, include or incorporate by reference audited financial statements and an auditor's opinion, the auditor must consider the guidance in PCAOB AU 550, *Other Information in Documents Containing Audited Financial Statements*. This guidance requires auditors to read pro forma financial information (and any other information) included in a filing, if applicable, and consider whether such information or the manner of its presentation is inconsistent with the audited financial statements. Any actions taken by the auditor will depend on facts and circumstances and the significance of the inconsistency.

The auditor's responsibilities with respect to Securities Act filings that include or incorporate by reference audited financial statements and an auditor's opinion are addressed in PCAOB AU 634, *Letters for Underwriters and Certain Other Requesting Parties* (PCAOB AU 634), (discussed in Section 8.1 below) and PCAOB AU 711, *Filings Under Federal Securities Statutes* (PCAOB AU 711).

PCAOB AU 711 requires an auditor who issues a consent in a Securities Act registration statement to read the entire prospectus and other pertinent parts of the registration statement (including any pro forma financial information included), in part to ensure the auditor's name isn't used in a way to indicate his or her responsibility is greater than intended (e.g., the experts section doesn't imply the financial statements were prepared by the auditor).

8.1 Comfort letters

An underwriter or other requesting party may request that an auditor comment in a comfort letter on pro forma financial information included in a registration statement, prospectus supplement or offering memorandum. PCAOB AU 634 provides guidance about the level of assurance that auditors may provide (e.g., negative assurance, procedures performed and findings obtained) on pro forma financial information. Certain criteria must be met before an auditor can provide negative assurance on pro forma financial information as it relates to compliance with Article 11 and the proper application of the pro forma adjustments. If such criteria aren't met, auditors generally can still report on the procedures performed and findings obtained in their comfort letter.

8.2 Reporting on pro forma financial information

In certain circumstances, a party to a transaction may request that an auditor report on pro forma financial information. Reporting on pro forma financial information is an attestation engagement covered by Statement on Standards for Attestation Engagements, *Reporting on Pro Forma Financial Information* (AT 401). Under AT 401, auditor's reports for general distribution are limited to (1) assurance based on an examination and (2) negative assurance based on a review.

When an auditor reports on an examination or a review of pro forma financial information, the auditor's assurances relate to whether (1) management's assumptions provide a reasonable basis for presenting the significant effects of the transaction or event reflected in the pro forma financial information, (2) the pro forma adjustments give appropriate effect to those assumptions and (3) the resulting pro forma amounts reflect the proper application of those adjustments to the historical amounts.

Illustration 8-1: Example examination report on pro forma financial information

Report of Independent Registered Public Accounting Firm[23]

Addressee:

The Board of Directors and Shareholders of XYZ Company

We have examined the pro forma adjustments reflecting the transaction [event] described in Note 1 and the application of those adjustments to the historical amounts in the accompanying pro forma condensed balance sheet of XYZ Company as of December 31, 20X4, and the pro forma condensed statement of comprehensive income [or "condensed statements of income, comprehensive income"] for the year then ended. The historical condensed financial statements are derived from the historical financial statements of XYZ Company, which were audited by us, and of ABC Company, which were audited by other accountants, appearing elsewhere herein [incorporated by reference].[24] Such pro forma adjustments are based upon management's assumptions described in Note 2. XYZ Company's management is responsible for the pro forma financial information. Our responsibility is to express an opinion on the pro forma financial information based on our examination.

Our examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included such procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [event] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [event] actually occurred earlier.

[Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.]

In our opinion, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [event] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 20X4, and the pro forma condensed statement of comprehensive income [or "condensed statements of income, comprehensive income"] for the year then ended.

/s/ [Name of independent registered public accounting firm]

[City, State (or Country)]

[Date]

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[23] If the audit firm is not registered with the PCAOB, this title should be "Report of Independent Auditors."

[24] If a report on the historical financial statements included a qualified opinion or an explanatory paragraph, add a sentence such as the following at the end of the second sentence (i.e., the reference to the audit of historical financial statements) of this report on the pro forma financial information: "Our report [The report of other accountants] included a qualified opinion [an explanatory paragraph] for [describe subject matter of modification]." The next sentence would then begin "The pro forma adjustments referred to above are based on…"

Illustration 8-2: Example review report on pro forma financial information

Report of Independent Registered Public Accounting Firm[25]

Addressee:

The Board of Directors and Shareholders of XYZ Company

We have reviewed the pro forma adjustments reflecting the transaction [event] described in Note 1 and the application of those adjustments to the historical amounts in the accompanying pro forma condensed balance sheet of XYZ Company as of March 31, 20X5, and the pro forma condensed statement of comprehensive income [or "condensed statements of income, comprehensive income"] for the three months then ended. The historical condensed financial statements are derived from the historical [unaudited] financial statements of XYZ Company, which were audited [reviewed] by us, and of ABC Company, which were audited [reviewed] by other accountants, appearing elsewhere herein [incorporated by reference]. [26] Such pro forma adjustments are based upon management's assumptions described in Note 2. XYZ Company's management is responsible for the pro forma financial information.

Our review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review is substantially less extensive in scope than an examination, the objective of which is the expression of an opinion on management's assumptions, the pro forma adjustments, and the application of those adjustments to historical financial information. Accordingly, we do not express such an opinion.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [event] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [event] actually occurred earlier.

[Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.]

Based on our review, nothing came to our attention that caused us to believe that management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [event] described in Note 1, that the related pro forma adjustments do not give appropriate effect to those assumptions, or that the pro forma column does not reflect the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of March 31, 20X5, and the pro forma condensed statement of comprehensive income [or "condensed statements of income, comprehensive income"] for the three months then ended.

/s/ [Name of independent registered public accounting firm]

[City, State (or Country)]

[Date]

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[25] If the audit firm is not registered with the PCAOB, this title should be "Report of Independent Auditors."

[26] If a report on the historical financial statements was an audit report and included a qualified opinion or an explanatory paragraph, add a sentence such as the following at the end of the second sentence (i.e., the reference to the audit of historical financial statements) of this review report on the pro forma financial information: "Our report [The report of other accountants] included a qualified opinion [an explanatory paragraph] for [describe subject matter of modification]." The next sentence would then begin "The pro forma adjustments referred to above are based on..." Any modifications of the auditor's report on the historical financial statements should be similarly described in the review report on the pro forma financial information.

The SEC staff has said that generally a consent is required when a Securities Act registration statement includes or incorporates by reference an auditor's examination or review report on pro forma financial information. A consent is not required if a review report applies only to interim financial statements and no part of the interim period covered by the report has been audited. In this case, the independent auditor must provide an acknowledgement letter under Item 601(15) of Regulation S-K.

Appendix: Pro forma financial information example

This pro forma information is assumed to be disclosed in an amendment to a Form 8-K that reported the closing of a significant business acquisition and that includes the financial statements of the acquired business that are required by S-X Rule 3-05.

UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL INFORMATION

ABC Company (the Company) acquired Target XYZ for total cash consideration of approximately $252.7 million on 25 August 20X5. The Company financed the acquisition by issuing new common shares and an additional fixed-rate term loan.

The following unaudited pro forma condensed combined financial statements are based on our historical consolidated financial statements and Target XYZ's historical consolidated financial statements as adjusted to give effect to the Company's acquisition of Target XYZ and the related financing transactions. The unaudited pro forma condensed combined statements of operations for the six months ended 30 June 20X5 and the 12 months ended 31 December 20X4 give effect to these transactions as if they had occurred on 1 January 20X4. The unaudited pro forma condensed combined balance sheet as of 30 June 20X5 gives effect to these transactions as if they had occurred on 30 June 20X5.

The assumptions and estimates underlying the unaudited adjustments to the pro forma condensed combined financial statements are described in the accompanying notes, which should be read together with the pro forma condensed combined financial statements.

The unaudited pro forma condensed combined financial statements should be read together with the Company's historical financial statements, which are included in the Company's latest annual report on Form 10-K and quarterly report on Form 10-Q, and Target XYZ's historical information included herein.

Unaudited Pro Forma Condensed Combined Balance Sheet

As of 30 June 20X5

(In thousands)

	ABC Company Historical	Target XYZ (Acquiree) Historical	Pro Forma Adjustments	Notes	Pro Forma Combined
Cash and cash equivalents	$ 10,428	$ 230	$ (7,980)	(a)	$ 2,678
Accounts receivable, net	78,940	24,890	680	(b)	104,510
Inventory	73,202	15,023	3,485	(c)	91,710
Prepaid expenses and other current assets	4,737	–	–		4,737
Total current assets	167,307	40,143	(3,815)		203,635
Property, plant and equipment, net	65,250	11,954	2,450	(d)	79,654
Intangible assets, net	128,539	36,246	68,394	(e)	233,179
Goodwill	101,326	50,805	120,469	(f)	272,600
Other noncurrent assets	10,772	–	–		10,772
Total assets	$ 473,194	$ 139,148	$ 187,498		$ 799,840

Accounts payable	$ 43,475	$ 30,144	$ 850	(b)	$ 74,469
Accrued liabilities and other current liabilities	4,804	228	17	(b)	5,049
Total current liabilities	48,279	30,372	867		79,518
Long-term debt	150,600	7,300	152,700	(g)	310,600
Deferred revenue	21,748	12,240	(5,890)	(h)	28,098
Deferred income taxes, net	29,323	6,237	30,800	(i)	66,360
Other noncurrent liabilities	5,491	–	–		5,491
Total liabilities	255,441	56,149	178,477		490,067
Total shareholders' equity	217,753	82,999	9,021	(j)	309,773
Total liabilities and shareholders' equity	$ 473,194	$ 139,148	$ 187,498		$ 799,840

See accompanying notes to the Unaudited Pro Forma Condensed Combined Financial Information

Unaudited Pro Forma Condensed Combined Statements of Operations

Six Months Ended 30 June 20X5

(In thousands, except per share information)

	ABC Company Historical	Target XYZ (Acquiree) Historical	Pro Forma Adjustments	Notes	Pro Forma Combined
Revenue	$ 255,870	$ 79,650	(1,630)	(h)	$ 333,890
Costs of revenue, exclusive of depreciation and amortization	148,430	45,600	(1,270)	(k)	192,760
Depreciation and amortization expense	18,890	3,489	330	(c)	26,774
			4,065	(d)	
Selling, general and administrative expense	47,180	12,390	1,270	(k)	63,540
			1,240	(l)	
			1,460	(m)	
Income from operations	41,370	18,171	(8,725)		50,816
Interest expense	3,760	200	3,945	(n)	7,905
Income before income taxes	37,610	17,971	(12,670)		42,911
Income taxes	13,910	6,920	(5,070)	(o)	15,760
Net income	$ 23,700	$ 11,051	$ (7,600)		$ 27,151
Basic and diluted earnings per share	$ 2.32				$ 1.71
Weighted-average shares	10,200		5,650	(p)	15,850

See accompanying notes to the Unaudited Pro Forma Condensed Combined Financial Information

Unaudited Pro Forma Condensed Combined Statements of Operations

Year Ended 31 December 20X4

(In thousands, except per share information)

	ABC Company Historical	Target XYZ (Acquiree) Historical	Pro Forma Adjustments	Notes	Pro Forma Combined
Revenue	$ 472,520	$ 151,310	(3,580)	(h)	$ 620,250
Costs of revenue, exclusive of depreciation and amortization	275,900	85,800	(2,530)	(k)	359,170
Depreciation and amortization expense	36,480	6,817	820	(c)	52,248
			8,131	(d)	
Selling, general and administrative expense	86,500	22,640	2,530	(k)	117,070
			2,480	(l)	
			2,920	(m)	
Income from operations	73,640	36,053	(17,931)		91,762
Interest expense	7,520	400	7,890	(n)	15,810
Income before income taxes	66,120	35,653	(25,821)		75,952
Income taxes	23,760	13,790	(10,330)	(o)	27,220
Net income	$ 42,360	$ 21,863	$ (15,491)		$ 48,732
Basic and diluted earnings per share	$ 4.32				$ 3.15
Weighted-average shares	9,800		5,650	(p)	15,450

See accompanying notes to the Unaudited Pro Forma Condensed Combined Financial Information

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(in thousands, except per share information)

Note 1 — Basis of presentation

The historical consolidated financial statements have been adjusted in the pro forma condensed combined financial statements to give effect to pro forma events that are (1) directly attributable to the business combination, (2) factually supportable and (3) with respect to the pro forma condensed combined statements of operations, expected to have a continuing impact on the combined results following the business combination.

The business combination was accounted for under the acquisition method of accounting in accordance with ASC Topic 805, *Business Combinations*. As the acquirer for accounting purposes, the Company has estimated the fair value of Target XYZ's assets acquired and liabilities assumed and conformed the accounting policies of Target XYZ to its own accounting policies.

The pro forma combined financial statements do not necessarily reflect what the combined company's financial condition or results of operations would have been had the acquisition occurred on the dates indicated. They also may not be useful in predicting the future financial condition and results of operations of the combined company. The actual financial position and results of operations may differ significantly from the pro forma amounts reflected herein due to a variety of factors.

The combined pro forma financial information does not reflect the realization of any expected cost savings or other synergies from the acquisition of Target XYZ as a result of restructuring activities and other planned cost savings initiatives following the completion of the business combination.

Note 2 — Financing transactions

The Company completed the acquisition of Target XYZ for approximately $252.7 million in cash. The Company financed the purchase by issuing 5,650,000 common shares for net proceeds of $100 million and incurring new debt of approximately $160 million, net of $7.5 million in debt issuance costs, in a 4.5% fixed rate term loan. The Company also used the debt proceeds to extinguish Target XYZ's existing debt of approximately $7.3 million.

Note 3 — Preliminary purchase price allocation

The Company has performed a preliminary valuation analysis of the fair market value of Target XYZ's assets and liabilities. The following table summarizes the allocation of the preliminary purchase price as of the acquisition date (in thousands):

Cash	$ 230
Accounts receivable	25,570
Inventory	18,508
Property, plant and equipment	14,404
Identifiable intangible assets	104,640
Goodwill	171,274
Accounts payable	(30,994)
Accrued expenses	(245)
Long-term debt	(7,300)
Deferred revenue	(6,350)
Deferred tax liabilities, net	(37,037)
Total consideration	**$ 252,700**

This preliminary purchase price allocation has been used to prepare pro forma adjustments in the pro forma balance sheet and income statement. The final purchase price allocation will be determined when the Company has completed the detailed valuations and necessary calculations. The final allocation could differ materially from the preliminary allocation used in the pro forma adjustments. The final allocation may include (1) changes in fair values of property, plant and equipment, (2) changes in allocations to intangible assets such as trade names, technology and customer relationships as well as goodwill and (3) other changes to assets and liabilities.

Note 4 — Pro forma adjustments

The pro forma adjustments are based on our preliminary estimates and assumptions that are subject to change. The following adjustments have been reflected in the unaudited pro forma condensed combined financial information:

(a) Represents the payment of the estimated transaction costs of $5.0 million related to the Target XYZ acquisition and the payment of $3.0 million in bonuses to five key executives upon closing of the transaction.

(b) Reflects the working capital adjustments based on the purchase price allocation as of the acquisition date as shown in Note 3.

(c) Represents the estimated adjustment to step up Target XYZ's finished goods and work in process inventory to a fair value of approximately $18.5 million, an increase of $3.5 million from the carrying value. The fair value calculation is preliminary and subject to change. The fair value was determined based on the estimated selling price of the inventory less the remaining manufacturing and selling costs and a normal profit margin on those manufacturing and selling efforts. After the acquisition, the step-up in inventory fair value of $3.5 million will increase cost of sales over approximately two months as the inventory is sold. This increase is not reflected in the pro forma condensed combined statements of operations because it does not have a continuing impact.

(d) Reflects the adjustment of $2.5 million to increase the basis in the acquired property, plant and equipment to estimated fair value of $14.4 million. The estimated useful lives range from three to seven years. The fair value and useful life calculations are preliminary and subject to change after the Company finalizes its review of the specific types, nature, age, condition and location of Target XYZ's property, plant and equipment. The following table summarizes the changes in the estimated depreciation expense (in thousands):

	Year ended 31 December 20X4	Six months ended 30 June 20X5
Estimated depreciation expense	3,200	1,600
Historical depreciation expense	(2,380)	(1,270)
Pro forma adjustments to depreciation expense	**$ 820**	**$ 330**

(e) Reflects the adjustment of historical intangible assets acquired by the Company to their estimated fair values. As part of the preliminary valuation analysis, the Company identified intangible assets, including technology, trade names, and customer relationships. The fair value of identifiable intangible assets is determined primarily using the "income approach," which requires a forecast of all of the expected future cash flows. Since all information required to perform a detailed valuation analysis of Target XYZ's intangible assets could not be obtained as of the date of this filing, for purposes of these unaudited pro forma condensed combined financial statements, the Company used certain assumptions based on publicly available transaction data for the industry.

The following table summarizes the estimated fair values of Target XYZ's identifiable intangible assets and their estimated useful lives (in thousands):

	Estimated Fair Value	Estimated Useful Life in Years	Year ended 31 December 20X4 Amortization Expense	Six months ended 30 June 20X5 Amortization Expense
Technology	67,800	10.0	6,800	3,400
Trade Names	28,000	7.0	4,000	2,000
Customer Relationships	8,840	5.0	1,768	884
	$ 104,640		12,568	6,284
Historical amortization expense			(4,437)	(2,219)
Pro forma adjustments to amortization expense			**$ 8,131**	**$ 4,065**

These preliminary estimates of fair value and estimated useful lives will likely differ from final amounts the Company will calculate after completing a detailed valuation analysis, and the difference could have a material impact on the accompanying unaudited pro forma condensed combined financial statements. A 10% change in the valuation of intangible assets would cause a corresponding increase or decrease in the balance of goodwill and annual amortization expense of approximately $1.3 million, assuming an overall weighted-average useful life of 8.3 years.

(f) Reflects adjustment to remove Target XYZ's historical goodwill of $51.5 million and record goodwill associated with the acquisition of $171.1 million as shown in Note 3.

(g) Reflects the new term debt incurred to finance the acquisition of Target XYZ, minus the effects of extinguishing XYZ's outstanding debt upon completion of the acquisition. The net increase to debt includes (in thousands):

Issuance of new term debt, net of debt issuance costs of $7.5 million		160,000
Decrease for extinguishment of existing Target XYZ debt		(7,300)
Pro forma adjustment to debt	**$**	**152,700**

(h) Represents the estimated adjustment to decrease the assumed deferred revenue obligations to a fair value of approximately $6.4 million, a $5.9 million decrease from the carrying value. The calculation of fair value is preliminary and subject to change. The fair value was determined based on the estimated costs to fulfill the remaining extended maintenance obligations plus a normal profit margin. After the acquisition, this adjustment will have a continuing impact and will reduce revenue related to the assumed performance obligations as the maintenance services are provided over the next two years. The pro forma adjustments to reduce revenue by $1.6 million for the six months ended 30 June 20X5 and $3.5 million for the year ended 31 December 20X4 reflect the difference between prepayments related to extended maintenance arrangements and the fair value of the assumed performance obligations as they are satisfied, assuming the transaction was completed on 1 January 20X4.

(i) Adjusts the deferred tax liabilities resulting from the acquisition. The estimated increase in deferred tax liabilities to $37.0 million stems primarily from the fair value adjustments for non-deductible intangible assets based on an estimated tax rate of 40%. This estimate of deferred income tax balances is preliminary and subject to change based on management's final determination of the fair value of assets acquired and liabilities assumed by jurisdiction.

(j) Represents the elimination of the historical equity of Target XYZ and the issuance of common shares to finance the acquisition, as follows (in thousands):

Net equity proceeds from the issuance of 5,650,000 common shares		100,000
Less: historical Target XYZ shareholders' equity as of 30 June 20X5		(82,999)
Less: one-time bonuses paid to executives upon closing		(3,000)
Less: transaction costs paid in connection with the acquisition[1]		(4,980)
Pro forma adjustment to shareholders' equity	**$**	**9,021**

(k) Reclassifies $1.3 million and $2.5 million from cost of revenues to selling and administrative expenses for the six months ended 30 June 20X5 and the year ended 31 December 20X4, respectively. The reclassifications relate to certain product distribution fees paid to customers that are classified by the Company as selling expenses.

1 For illustrative purposes, we assumed that there are no is tax benefit related to the transaction costs.

(l) Reflects new compensation arrangements with five key executives in connection with the business combination, resulting in a $2.5 million increase in the annual compensation for these executives from their previous compensation. Accordingly, adjustments of $1.2 million for the six months ended 30 June 20X5 and $2.5 million for the year ended 31 December 20X4 are reflected in the pro forma statements of operations. However, the pro forma statements of operations do not include $3.0 million in bonuses to these executives, which were payable upon closing of the business combination, because these items will not have a continuing impact on operations.

(m) Represents the difference between Target XYZ's historical share-based compensation expense and the estimated share-based compensation expense related to replacement awards issued to continuing employees as part of the acquisition agreement. The fair value of the replacement share-based awards, including stock options and restricted stock units, will be recognized ratably over the remaining post-combination service periods ranging for two to three years.

(n) Represents the net increase to interest expense resulting from interest on the new term debt to finance the acquisition of Target XYZ and the amortization of related debt issuance costs, as follows (in thousands):

	Year ended 31 December 20X4	Six months ended 30 June 20X5
Elimination of interest expense and amortization of debt issuance costs — Target XYZ debt	(400)	(200)
Interest expense on new 4.5% term debt	7,540	3,770
Amortization of new debt issuance costs	750	375
Pro forma adjustments to interest expense	**$ 7,890**	**$ 3,945**

(o) Reflects the income tax effect of pro forma adjustments based on the estimated blended federal and state statutory tax rate of 40%.

(p) Represents the increase in the weighted average shares in connection with the issuance of 5,650,000 common shares to finance the acquisition.

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