SEC Financial Reporting Series

Pro forma financial information

A guide for applying amended Article 11 of Regulation S-X

January 2021

Building a better working world

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1 Overview

We are pleased to present this publication, *Pro forma financial information: a guide for applying amended Article 11 of Regulation S-X*. Pro forma financial information (pro formas) presents historical balance sheet and income statement information adjusted as if a transaction had occurred at an earlier time. Pro formas are intended to provide investors with information about the effect of a transaction by showing how a transaction or a group of transactions might have affected historical financial statements to illustrate the scope of the change in the registrant's financial position and results of operations.

Article 11 of Regulation S-X, *Pro forma financial information*, describes the requirements of the Securities and Exchange Commission (SEC) for registrants to provide pro formas.

In May 2020, the SEC amended its requirements for registrants to provide information about significant business acquisitions and disposals.[1] Among other things, the new rules changed the significance tests used to determine whether registrants need to file audited financial statements of an acquired business and related pro formas, the periods the financial statements must cover, and the form and content of the pro formas.[2]

This edition reflects the final rules in SEC Release 33-10786, *Amendments to Financial Disclosures about Acquired and Disposed Businesses*. The rules were effective 1 January 2021 for calendar year-end companies and will be effective on the first day of a different fiscal year that begins after 31 December 2020. Earlier compliance is permitted. Registrants that are applying the legacy rules should refer to our **December 2019 edition** of this publication.

1.1 Section highlights

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

- Section 2 describes the events and circumstances that require registrants to present Article 11 pro formas in SEC filings.
- Section 3 discusses which SEC forms require Article 11 pro formas.
- Section 4 walks through the content requirements for pro formas, including the required historical financial information and adjustments to the historical information.
- Section 5 shows the pro forma adjustments and disclosures typically required for common transactions.
- Section 6 highlights other considerations, including pro forma disclosure related to initial public offering (IPO) transactions, disclosure in management's discussion and analysis (MD&A) and the use of non-GAAP measures.
- Section 7 covers auditors' responsibilities and their involvement with respect to pro formas.

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[1] SEC Release 33-10786, ***Amendments to Financial Disclosures about Acquired and Disposed Businesses (Final Rule)***.

[2] See our Technical Line, ***Applying the SEC's new requirements for significant acquired businesses***.

1.2 EY publications and checklists

Our publications and checklists provide interpretive guidance to help registrants prepare various SEC forms and schedules. These documents are available from any EY representative.

- Technical Line, ***Applying the SEC's new requirements for significant acquired businesses*** — This publication discusses all of the disclosure requirements (including pro formas) for reporting on common acquisition transactions.
- Technical Line, ***How to apply the amended S-X Rule 3-14 to real estate acquisitions*** — This publication explains when a registrant is in the scope of this specialized industry guidance, how to measure significance when acquiring a real estate operation and what financial information is required.
- SEC Reporting Update, ***Highlights of trends in 2020 SEC comment letters*** — 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.

1.3 Other considerations

Reading our publication is not a substitute for reading Article 11 or the applicable form instructions that require pro formas. Registrants should also consider the following resources that describe SEC staff views about complying with Article 11. Since the SEC staff had not yet updated its guidance to reflect the amendments to Article 11 by the issuance date of this publication, registrants should confirm the relevance of the guidance referred to below.

- The Financial Reporting Manual (FRM) provides views on financial reporting matters from the Division of Corporation Finance's Office of Chief Accountant.[3] The SEC staff's interpretations and guidance about pro forma financial information are included in Topic 3 of the FRM.
- The highlights of meetings the Center for Audit Quality (CAQ) SEC Regulations Committee holds periodically with the SEC staff describe the staff's views on emerging financial reporting issues relating to SEC rules and regulations. The highlights can be found on the CAQ's website.[4]
- Staff Accounting Bulletins (SABs) provide the SEC staff's views on accounting-related disclosure practices. They reflect the interpretations and policies followed by the SEC's Division of Corporation Finance and the Office of the Chief Accountant and are codified in the Codification of Staff Accounting Bulletins. There are only a limited number of SABs (e.g., SAB Topics 1.B.2 and 1.B.3) that address pro forma financial information under the legacy rules.

1.3.1 ASC 805 pro forma requirements

Accounting Standards Codification (ASC) 805-10-50-2(h) requires an entity to disclose certain pro forma information in the footnotes to its financial statements when the entity has completed a material business combination. ASC 805, *Business Combinations*, 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. Entities also must provide a narrative description of the nature and amount of material nonrecurring adjustments.

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[3] The FRM can be found at http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml.

[4] The CAQ SEC Regulations Committee highlights can be found on the CAQ website at https://www.thecaq.org/about-us/our-committees/sec-regulations-committee/.

Under the amended SEC rules, Article 11 pro forma disclosures on nonrecurring items will align more closely with ASC 805 disclosures, but ASC 805 pro forma disclosures will still be substantially less detailed than disclosures in Article 11 pro formas. Many registrants, nevertheless, will continue to apply the principles in Article 11 to prepare their ASC 805 pro forma disclosures because ASC 805 does not provide guidance on how entities should calculate the items that must be disclosed (pro forma revenue and earnings). See section 4.4.1.1, *Nonrecurring items*, for details.

It is also important to note that registrants determining whether to include ASC 805 pro forma information in the footnotes to their financial statements evaluate whether the information is material, while registrants determining whether to present Article 11 pro formas evaluate whether the acquired business exceeds a significance threshold (see section 2.2.2). As a result, a registrant may need to make supplemental pro forma disclosures under ASC 805, even when Article 11 pro formas are not required.

Refer to our Financial reporting developments (FRD) publication, ***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 formas in offering documents other than registration statements under the Securities Act of 1933 (Securities Act) or Exchange Act of 1934 (Exchange Act). Financial statements and other information (including pro formas) included in these offering documents (e.g., exempt offering memoranda for Rule 144A offerings) are not subject to SEC form instructions or the requirements of Regulation S-X. Instead, third-party broker-dealers or financial intermediaries associated with the offering determine what information should be provided. Therefore, the requirements of 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 provide a helpful framework for preparing pro formas 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 formas 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 must be filed 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 acquisition has occurred (for purposes of this section, 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 Regulation S-X Rule 3-01, consummation of a significant business acquisition 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) Reserved;

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

Companies must present Article 11 pro formas when certain transactions occur or become probable, including:

- Significant acquisitions of businesses, including those that meet the definition of a real estate operation (refer to section 5.1, *Business combinations,* and section 5.2, *Acquisition of equity method investments*, for further discussion)

- Significant disposals of businesses, including real estate operations (refer to section 5.3, *Disposals,* for further discussion)
- Spin-offs (refer to section 5.4, *Spin-off transactions*, for further discussion)
- Roll-up transactions (refer to section 6.3, *Roll-up transactions*, for further discussion)
- Any other transaction that has occurred or is probable for which disclosure of pro formas would be material to investors

Materiality for this purpose depends on the facts and circumstances of the event or transaction and can also include the following:

- Repayment or refinancing of debt (refer to section 5.1.4, *Debt*, for further discussion)
- Emergence from bankruptcy (refer to section 5.5.2, *Emergence from bankruptcy*, for further discussion)
- Receipt and application of offering proceeds (refer to section 5.5.3, *Use of proceeds in securities offerings*, for further discussion)
- Declaring dividends after the most recent balance sheet date (refer to section 6.1.1, *Planned distributions not reflected in the historical balance sheet*, and section 6.1.2, *Distribution in excess of earnings,* for further discussion)
- Changes in tax status, such as converting a subchapter S corporation or partnership to a C corporation (refer to section 6.1.3, *Changes in tax status*, for further discussion)
- Changes in capitalization at or prior to closing of an IPO (refer to section 6.1.4, *Other changes in capitalization*, for further discussion)

2.2 Significant business acquisitions and disposals

Article 11 pro formas are required if a significant acquisition of a business or real estate operation has occurred in the latest fiscal year or subsequent interim period or is probable. Significant acquisitions include any transaction or event that results in the registrant obtaining control (e.g., consolidation by contract) as well as the acquisition of a significant equity method investment.

Article 11 pro formas are also required if a disposal of a significant business or real estate operation by sale, abandonment or distribution to shareholders has occurred or is probable.

The requirements to provide pro formas are triggered when an acquisition or disposal is more than 20% significant to a registrant. See section 2.2.2 for details of how significance is measured. Because a transaction involving a business that also meets the definition of a real estate operation is treated differently under Regulation S-X than one involving a business that doesn't meet the definition of a real estate operation, this type of transaction is discussed separately below. See also our Technical Line, ***How to apply the amended S-X Rule 3-14 to real estate acquisitions***.

In general, whenever audited historical financial statements of an acquired business or real estate operation are required, Article 11 pro formas also must be presented. Article 11 pro formas also may be necessary if an acquired business or real estate operation of the registrant consummated a significant acquisition 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.

Generally, the SEC staff considers presenting separate financial statements of an acquired business or real estate operation without accompanying pro formas to be misleading. Likewise, pro formas are not required to be presented for an acquisition if separate financial statements are not required in the filing, except in certain cases involving individually insignificant acquisitions that are significant in the aggregate. See sections 2.2.2.3 and 2.2.2.6 for more about these situations.

2.2.1 Definition of a business

To determine whether S-X Article 11 applies, a registrant must first determine whether the assets and liabilities it is acquiring or disposing of meet the SEC's definition of a business in S-X Rule 11-01(d).

Under Rule 11-01(d), the general principle for identifying a business is that there must be continuity of the revenue-producing activity before and after the transaction, and the financial information about the acquired or disposed business is therefore material to an understanding of the registrant's operations after the transaction. There is a presumption that a separate entity, subsidiary, division or working interest in an oil and gas property is a business. S-X Rule 11-01(a)(1) also defines as a business an investment accounted for using the equity method.

Other components of a selling entity, such as a product line, may also be considered a business for SEC reporting purposes. When evaluating whether such a component is a business, registrants must consider the criteria in S-X Rule 11-01(d). However, these attributes are not all-inclusive, and registrants must use judgment to evaluate the criteria.

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.

The SEC staff's analysis of whether a set of assets and liabilities constitutes a business focuses primarily on whether the nature of the revenue-producing activity associated with the acquired or disposed assets will remain generally the same after the transaction. The SEC's definition of a business differs from the US GAAP definition in ASC 805; therefore, it is possible to reach a different conclusion about whether a business has been acquired under Article 11 and ASC 805.

Illustration 1-1 — Definition of a business in an acquisition
Registrant A is acquiring certain assets related to Product X from Company B. No employees will move from Company B to Registrant A, and the transaction involves only the internally generated intangible assets (e.g., brand name, manufacturing know-how) and inventory related to Product X. Product X is not a separate entity, subsidiary or division of Company B. After the acquisition, Registrant A will sell Product X to Company B's customers. Because the nature of the revenue-producing activity associated with Product X will remain the same after the acquisition and multiple attributes listed in S-X Article 11 will remain with Product X, Registrant A concludes that the transaction involves a business.

If a registrant believes that it may be able to overcome the presumption that a separate entity, subsidiary, division or working interest in an oil and gas property is a business or is uncertain whether the criteria in S-X Rule 11-01(d) have been met, we recommend that the registrant contact the SEC staff to discuss whether a business has, in fact, been acquired. When the answer is unclear, it may also be helpful to consider whether the information conveyed in Rule 3-05 financial statements would be useful to investors.

2.2.1.1 Definition of a real estate operation

Rule 3-14 of Regulation S-X, *Special instructions for financial statements of real estate operations acquired or to be acquired*, requires registrants to present the audited financial statements and Article 11 pro formas of significant consummated and probable acquisitions of real estate operations. In addition, Article 11 requires pro formas when a registrant disposes of a significant real estate operation.

A real estate operation is a business that generates substantially all of its revenues through the leasing of real property. A registrant must evaluate a property's rental history in order to determine whether it meets the definition. The SEC staff has said that it is not necessary to provide financial statements or pro formas for an acquired property that has less than three months of history (including newly constructed properties) or a rental property that will be demolished and replaced with a new rental property.

The definition encompasses an investment in a real estate operation accounted for using the equity method. Please refer to our Technical Line, ***How to apply the amended S-X Rule 3-14 to real estate acquisitions***, for further explanations of what constitutes a real estate operation, how to measure significance and what financial information is required when a registrant acquires a significant real estate operation.

2.2.2 Measuring significance

Significance is calculated as a percentage (that cannot be rounded) using the asset test, the investment test and the income test applicable to the transaction as described in S-X Rule 1-02(w). More details about how the tests should be applied are included in Article 11 and Rules 3-05 and 3-14 for acquisitions of businesses and real estate operations, respectively.

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.

(1) The term *significant subsidiary* means a subsidiary, including its subsidiaries, which meets any of the conditions in paragraphs (w)(1)(i), (ii), or (iii) of this section; however if the registrant is a registered investment company or a business development company, the tested subsidiary meets any of the conditions in paragraph (w)(2) of this section instead of any of the conditions in paragraph (w)(1) of this section. A registrant that files its financial statements in accordance with or provides a reconciliation to US GAAP must use amounts determined under US GAAP. A foreign private issuer that files its financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) must use amounts determined under IFRS-IASB.

(i) Investment test.

(A) For acquisitions, other than those described in paragraph (B), and dispositions this test is met when the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent[1] of the aggregate worldwide market value of the registrant's voting and non-voting common equity, or if the registrant has no such aggregate worldwide market value the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

(1) For acquisitions, the "investments in" the tested subsidiary is the consideration transferred, adjusted to exclude the registrant's and its other subsidiaries' proportionate interest in the carrying value of assets transferred by the registrant and its subsidiaries consolidated to the tested subsidiary that will remain with the combined entity after the acquisition. It must include the fair value of contingent consideration if required to be recognized at fair value by the registrant at the acquisition date under US GAAP or IFRS-IASB, as applicable; however if recognition at fair value is not required, it must include all contingent consideration, except contingent consideration for which the likelihood of payment is remote.

(2) For dispositions, the "investments in" the tested subsidiary is the fair value of the consideration, including contingent consideration, for the disposed subsidiary when comparing to the aggregate worldwide market value of the registrant's voting and non-voting common equity, or, when the registrant has no such aggregate worldwide market value, the carrying value of the disposed subsidiary when comparing to total assets of the registrant.

(3) When determining the aggregate worldwide market value of the registrant's voting and non-voting common equity, use the average of such aggregate worldwide market value calculated daily for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition.

(B) For a combination between entities or businesses under common control, this test is met when either the net book value of the tested subsidiary exceeds 10 percent of the registrant's and its subsidiaries' consolidated total assets or the number of common shares exchanged or to be exchanged by the registrant exceeds 10 percent of its total common shares outstanding at the date the combination is initiated.

(C) In all other cases, this test is met when the registrant's and its other subsidiaries' investments in and advances to the tested 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.

(ii) Asset test. This test is met when the registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total assets (after intercompany eliminations) exceeds 10 percent[1] of such total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

(iii) Income test.

(A) This test is met when:

(1) The absolute value of the registrant's and its other subsidiaries' equity in the tested subsidiary's consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) attributable to the controlling interests exceeds 10 percent of the absolute value of such income or loss of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; and

(2) The registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total revenue from continuing operations (after intercompany eliminations) exceeds 10 percent of such total revenue of the registrant and its subsidiaries consolidated for the most recently completed fiscal year. This component does not apply if either the registrant and its subsidiaries consolidated or the tested subsidiary did not have material revenue in each of the two most recently completed fiscal years.

(B) When determining the income component in paragraph (w)(1)(iii)(A)(1) of this section:

(1) If a net loss from continuing operations before income taxes (after intercompany eliminations) attributable to the controlling interest has been incurred by either the registrant and its subsidiaries consolidated or the tested subsidiary, but not both, exclude the equity in the income or loss from continuing operations before income taxes (after intercompany eliminations) of the tested subsidiary attributable to the controlling interest from such income or loss of the registrant and its subsidiaries consolidated for purposes of the computation;

(2) Compute the test using the average described in this paragraph (w)(1)(iii)(B)(2) if the revenue component in paragraph (w)(1)(iii)(A)(2) of this section does not apply and the absolute value of the registrant's and its subsidiaries' consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) attributable to the controlling interests for the most recent fiscal year is at least 10 percent lower than the average of the absolute value of such amounts for each of its last five fiscal years; and

(3) Entities reporting losses must not be aggregated with entities reporting income where the test involves combined entities, as in the case of determining whether summarized financial data must be presented or whether the aggregate impact specified in S-X Rules 3-05(b)(2)(iv) and 3-14(b)(2)(i)(C) is met, except when determining whether related businesses meet this test for purposes of Rules 3-05 and 8-04.

(2) *[Omitted from this publication]*

[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%.

2.2.2.1 Significant business acquisitions

In most cases, the significance tests described below are performed using amounts that appear in the registrant's most recent annual pre-acquisition audited financial statements filed with the SEC and amounts in the financial statements of the acquired business for the same fiscal year. The details of the tests are as follows:

- Asset test — Significance is measured by comparing the registrant's proportionate share of the acquired business's total assets (after intercompany eliminations) to its consolidated total assets.
- Investment test — Significance is measured by comparing the consideration transferred (typically consistent with US GAAP) to an average aggregate worldwide market value of the registrant's voting and non-voting common equity (WWMV), or the total assets of the registrant if WWMV is not available (i.e., when common equity is not publicly traded, as is the case for a company conducting an IPO).
- Income test — Significance is measured using the lower result of the following two components unless either the registrant or the acquired business did not have material revenue during each of their past two years, in which case only the income component is used:
  - Income component — This component compares the registrant's proportionate share of the acquired business's income or loss from continuing operations before taxes, net of amounts attributable to any noncontrolling interest, to that of the registrant.
  - Revenue component — This component compares the registrant's proportionate share of the acquired business's most recent annual consolidated revenue from continuing operations to that of the registrant.

Refer to our Technical Line, ***Applying the SEC's new requirements for significant acquired businesses***, for further discussions (including examples) about measuring significance for business acquisitions.

2.2.2.2 Related businesses

The acquisition of related businesses must be treated as a single acquisition. Businesses are considered related if they are under common control or management, the acquisition of one business is conditional on the acquisition of each other business, or each acquisition is conditioned on a single common event.

While the related businesses must be 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*.

To perform the tests for the group as a whole, a registrant must aggregate the amounts for each business, and the highest test result using those amounts represents the significance of the group. That is, if the significance of the group exceeds 20% for at least one test, Rule 3-05 financial statements and pro formas are required for each of the related businesses, even if the significance of one or more of them is 20% or less for all three tests. Companies should include related acquisitions that have occurred in the period after the latest audited fiscal year end and, for registration statements, include related acquisitions that are probable.

2.2.2.3 Business acquisitions that are individually insignificant

Registrants must also consider the aggregate significance of certain acquisitions that are not individually significant when filing a registration statement or proxy statement. Significance is calculated as if the acquisitions were a single acquisition and include:

- Acquisitions consummated after the registrant's most recent audited balance sheet date that are 20% or less significant

- Probable acquisitions that are 50% or less significant
- Completed acquisitions that are more than 20% but not more than 50% significant for which Rule 3-05 financial statements and pro formas are not yet required because the filing or effective date of a registration statement or mailing date of a proxy falls within 74 days of consummation

If the aggregate significance of these acquisitions exceeds 50% for any of the three tests, a registrant is required to include in a registration or proxy statement pro formas that depict the aggregate effect of all individually insignificant acquisitions in all material respects. Rule 3-05 financial statements (covering the most recent fiscal year and interim period) for any of these acquisitions that exceed 20% must also be included.

Refer to our Technical Line, ***Applying the SEC's new requirements for significant acquired businesses***, for further discussion and examples of how to calculate aggregate significance of individually insignificant acquisitions.

2.2.2.4 Significant business disposals

Significance for business disposals is calculated using the three tests specified for disposals in S-X 1-02(w)(1). These tests are consistent with the tests used for acquired businesses, except the numerator of the investment test is the fair value of the consideration received, including contingent consideration. The denominator of the income test should not include the results of the business that is disposed of 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 pretax income or loss from continuing operations.

Refer to section 3.1 for additional considerations related to Form 8-K when reporting disposals.

2.2.2.5 Acquisitions of significant real estate operations

Significance for acquisitions of real estate operations is determined using the investment test used for acquisitions of a business. However, the numerator must include any debt secured by the property that is assumed by the registrant when WWMV is not available and total assets are used as the denominator. Related real estate operations are treated the same way as related businesses. Special tests can be used when a registrant conducts a "blind pool" offering or enters into a transaction to form a real estate investment trust. Refer to our Technical Line, ***How to apply the amended S-X Rule 3-14 to real estate acquisitions***, for further discussion.

2.2.2.6 Acquisition of individually insignificant real estate operations

When filing a registration statement or proxy statement, a registrant must also calculate the aggregate significance of acquisitions that do not individually trigger a requirement to include Rule 3-14 financial statements and pro formas. The real estate operations are identified in the same way that individually insignificant businesses are, as described in section 2.2.2.3.

If the aggregate significance of these acquisitions exceeds 50% for any of the three tests, a registrant is required to include in a registration statement or proxy statement pro formas that depict the aggregate effect of all individually insignificant acquisitions in all material respects. Rule 3-14 financial statements for any of these acquisitions that exceed 20% significance must also be included.

If the registrant acquires both businesses subject to Rule 3-05 and real estate operations subject to Rule 3-14, the registrant must use the significance tests that apply to each type of transaction. When aggregating significance, the registrant must include both the businesses and the real estate operations.

Please refer to our Technical Line, ***How to apply the amended S-X Rule 3-14 to real estate acquisitions***, for further discussion.

2.2.2.7 Exchange transactions

In an exchange transaction, the registrant and another party contribute businesses to a joint venture 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 of (i.e., contributed by the registrant) and separately measure the significance of the business being acquired (i.e., contributed by the other party). The significance of the business being acquired should be calculated based only on the portion of the business being acquired, and the significance of the business being disposed of should be calculated based only on the portion of the business being disposed of.

2.3 Spin-off of a portion of an entity

Article 11 pro forma information is 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 typically 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 they qualify as autonomous entity adjustments. Refer to section 4.4.2 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 for significant acquisitions and disposals. Pro formas for other transactions are generally required only in registration statements and proxy statements. Periodic reporting Forms 10-K and 10-Q do not require Article 11 pro formas.

3.1 Form 8-K

Form 8-K requires pro forma financial information under Article 11 or Rule 8-05 of Regulation S-X[5] for smaller reporting companies for acquisitions and disposals of significant businesses and real estate operations, including significant equity method investments. These transactions must first be reported under Item 2.01 of Form 8-K within four business days of completion of the transaction. For counting purposes, day one is the first business day after the day on which the transaction occurred.

If a registrant is unable to provide the required pro formas for a significant acquisition when the Item 2.01 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(a)(4)).

The 71-day extension allowed by Item 9.01(a)(4) of Form 8-K is not available for disposals because separate audited financial statements are not required. That is, the pro formas reflecting the disposal must be provided within four business days of its completion.

While each significant acquisition or disposal triggers separate disclosure under Item 2.01 of Form 8-K and the filing of pro formas under Item 9.01 of Form 8-K, companies typically provide cumulative pro formas when they make subsequent significant acquisitions or disposals in the same year. The SEC staff encourages this presentation because it provides more comprehensive disclosure.

For example, consider a registrant that completes a significant acquisition during the first quarter of its current fiscal year and reports timely pro forma and historical financial statements for that acquisition under Item 9.01 of Form 8-K within the 71-day grace period. If the registrant completes another significant acquisition in the third quarter of the same fiscal year, the instructions in Item 9.01(b) of Form 8-K would only require the registrant to file pro formas reflecting the second acquisition. However, the registrant may decide to include both transactions in the pro forma information filed in the second Form 8-K to provide more comprehensive disclosure.

A registrant that reflects both acquisitions in such cumulative pro formas should refer to section 4.6.1, *Pro formas involving multiple transactions*.

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[5] S-X Rule 8-05 was amended to refer to the provisions of Article 11. Prior to the amendments, Rule 8-05 was a standalone requirement that lacked the specificity of Article 11.

3.1.1 Exchange transaction

As discussed in section 2.2.2.7, a registrant may need to report both the acquisition of the equity method investment and the disposal of the business(es) it contributed in an exchange transaction. In these cases, the 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(es) contributed by the other party are not available.

If that's the case, the SEC staff will not object to the registrant filing complete pro forma information depicting the effects of the exchange of interests (i.e., its disposal of the business(es) it contributed and its acquisition of the equity interest in the joint venture) at the time that the audited financial statements of the business contributed by the other party are filed (within the 71-calendar-day extension) if the initial Form 8-K reporting the transaction includes a description of the effects of the disposal and quantifies those effects, if practicable.

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 listed in section 2.1 is probable or has occurred during the latest annual period or in the period since the latest annual balance sheet on file. However, a registrant can omit pro formas when, under S-X Rules 3-05 and 3-14, it can also omit the separate financial statements of an acquired business or real estate operation that has been included in the registrant's audited results for at least nine months.

If the registrant has multiple significant transactions (or multiple acquisitions that are individually insignificant but significant in the aggregate), such transactions may all need to be included in the pro formas in a registration or proxy statement. Accordingly, the pro formas required in registration or proxy statements may include more transactions than those filed by the registrant in its most recent Form 8-K reporting a significant transaction.

Furthermore, some registrants voluntarily include insignificant transactions that they are not required to reflect in the pro formas in a registration or proxy statement to illustrate more fully the consequences of recent transactions. A registrant that elects to reflect such transactions needs to consider whether the pro forma financial information would be misleading if it excludes other individually insignificant transactions.

Refer to section 6.7, *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 applicable to significant transactions in 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[6]	Yes — pro forma disclosures must be provided, when applicable.	Item 11(e)
Form S-3	Yes — registrants 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) Recent Exchange Act filing, such as Form 8-K (2) Proxy or information statement (3) 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.[7]	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

Proxy statements

A proxy statement filed on Schedule 14A may require Article 11 pro forma information in Item 13 when it 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

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[6] An emerging growth company (EGC) is permitted to omit pro forma financial information otherwise required by Article 11 of Regulation S-X from the registration statement for its IPO on Form S-1 or Form F-1 if the EGC reasonably believes that the pro forma information will not be required at the time of the offering. An EGC's IPO registration statement may not omit interim pro forma information that will become part of the pro forma financial information for a longer period required to be included at the time of offering. See the SEC staff's FRM Section 10220.5.

[7] Such unrelated pro forma information must be presented with, but clearly distinguished from, the pro forma information relating to the transaction. See section 4.6.1 for additional discussion and an example about how to present multiple transactions.

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 to be issued 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 shown in the table above.

Shelf registration statements

Annual reports that are automatically incorporated by reference into a shelf registration statement do not require Article 11 pro formas.

However, before conducting a shelf offering, a registrant must consider whether a completed acquisition of a business or real estate operation that is 50% or less significant, for which financial statements and pro formas have not been filed, represents a "fundamental change" as defined by Rule 512 of Regulation S-K. Probable acquisitions must also be considered. If an acquisition meets that definition, the financial statements and pro formas must be filed before the registrant conducts the offering. While such acquisitions rarely meet the definition of a fundamental change, the determination is a legal matter that a registrant should discuss with its legal counsel.

3.3 Foreign private issuer forms

A foreign private issuer (FPI) is not required to file Form 8-K. Rather, 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 disposals. However, Form 6-K does not include an item analogous to 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 Preparation 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(a), Preparation requirements, Form and content

(1) Pro forma financial information must consist of a pro forma condensed balance sheet, pro forma condensed statements of comprehensive 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 disclosed in lieu of the statements described in this paragraph (a)(1).

(2) The pro forma financial information must be accompanied by an introductory paragraph which briefly sets forth a description of (i) each transaction for which pro forma effects is being given, (ii) the entities involved, (iii) the periods for which the pro forma financial information is presented, and (iv) an explanation of what the pro forma presentation shows.

(3) The pro forma condensed financial information need only include major captions (i.e., the numbered captions) prescribed by the applicable sections of Regulation S-X. Where any major balance sheet caption is less than 10 percent of total assets, the caption may be combined with others. When any major statement of comprehensive income 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 must be used for purposes of this test. Notwithstanding these tests, de minimis amounts need not be shown separately.

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

(5) The pro forma condensed statement of comprehensive income must disclose income (loss) from continuing operations and income or loss from continuing operations attributable to the controlling interest.

Article 11 pro formas generally consist of an introductory section, pro forma condensed balance sheet, pro forma condensed statements of comprehensive income and explanatory notes. Pro forma statements of cash flows or shareholders' equity are not required. While Article 11 uses the term "pro forma statement of comprehensive income," pro forma financial information is not required for other

comprehensive income (OCI),[8] so Article 11 effectively requires the equivalent of an income statement through income (loss) from continuing operations. Accordingly, we have used the term "income statement" throughout this publication to refer to the statement of comprehensive income required under Article 11.

The pro forma financial statements are presented in columnar form with separate columns depicting the historical financial information of the registrant, the historical financial information of the businesses that have been acquired or disposed of (if applicable), the pro forma adjustments (as described in section 4.4) and a total or combined column.

The requirements of Article 11 apply to all registrants, although smaller reporting companies can condense the information in accordance with Regulation S-X 8-03(a).

4.2 Required statements and periods presented

A registrant's pro formas typically include the most recent condensed balance sheet and condensed income statement for its most recent annual and year-to-date interim period. These statements must include the captions required by Article 5 of Regulation S-X but can be condensed as described below. De minimis amounts do not need to be shown separately.

The age of the pro forma balance sheet and income statements are determined at the earlier of the filing or due date of the initial Item 2.01 Form 8-K for a significant acquisition or disposal and at the filing and effective date of a registration statement (or mailing date of a proxy statement) for all transactions.

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 Regulation S-X Rule 3-01 must be filed unless the transaction is already reflected in such balance sheet.

(2) (i) Pro forma condensed statements of comprehensive income must be filed for only the most recent fiscal year, except as noted in paragraph (c)(2)(ii) of this section, 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 comprehensive income may be filed for the corresponding interim period of the preceding fiscal year. A pro forma condensed statement of comprehensive income must not be filed when the historical statement of comprehensive income reflects the transaction for the entire period.

(ii) For transactions required to be accounted for under US GAAP or, as applicable, IFRS-IASB by retrospectively revising the historical statements of comprehensive income (e.g., combination of entities under common control and discontinued operations), pro forma statements of comprehensive income must be filed for all periods for which historical financial statements of the registrant are required. Retrospective revisions stemming from the registrant's adoption of a new accounting principle must not be reflected in pro forma statements of comprehensive income until they are depicted in the registrant's historical financial statements.

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[8] The statement of comprehensive income usually includes all components of net income and OCI. OCI includes all nonowner changes in equity that are included in comprehensive income but excluded from net income (e.g., unrealized gains/losses on available-for-sale securities, foreign currency translation adjustments, gains/losses associated with pension or other post-retirement benefits).

(3) Pro forma condensed statements of comprehensive income must 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 one fiscal quarter, the other entity's statements of comprehensive income must be brought up to within one fiscal quarter 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 must 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 statements of comprehensive income (e.g., an interim period that is included both as part of the fiscal year and the subsequent interim period).

Instruction 1 to paragraph (c)(3) In circumstances where different fiscal year ends exist, Regulation S-X Rule 3-12 may require a registrant to include in the pro forma financial information an acquired or to be acquired foreign business historical period that would be more current than the periods included in the required historical financial statements of the foreign business.

(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 statements of comprehensive income for the most recent twelve-month period in addition to those required in paragraph (c)(2)(i) of this section if the most recent twelve-month period is more representative of normal operations.

4.2.1 Pro forma condensed balance sheet

A registrant must include a pro forma condensed balance sheet as of the end of the most recent annual or interim period filed or required to be filed by S-X Rule 3-01. 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.

Generally, the historical balance sheet of an acquired business included in a pro forma presentation should be as of the same date unless the business has a different fiscal year end (refer to section 4.2.4, *Combining entities with different fiscal years*). If the transaction is already reflected in the registrant's latest balance sheet included in the filing, a pro forma balance sheet is not required. For example, a pro forma balance sheet reflecting a significant acquisition or disposal that closed during the first quarter is not required when a registrant incorporates its first-quarter Form 10-Q by reference into a registration statement.

The pro forma balance sheet can be condensed by combining items that are less than 10% of total assets with others.

4.2.2 Pro forma condensed income statement

Pro forma income statements are required for the registrant's most recent fiscal year and any subsequent year-to-date interim period filed or required to be filed by S-X Rule 3-02. Generally, the historical income statements of an acquired business should be for the same periods, unless the business has a different fiscal year end. An income statement for the corresponding interim period of the preceding fiscal year is optional. Once the transaction has been reflected in a registrant's results for an entire period required to be presented in the pro formas, that period is not required and should not be presented. In addition, as discussed in section 3.2, a registrant is able to omit the pro formas related to an acquisition if it can omit the separate financial statements required by S-X Rules 3-05 or 3-14.

S-X Rule 11-02(c)(2) prohibits a registrant from presenting more than one annual period of pro forma results of operations unless one of the transactions described in section 4.2.2.1 below is involved.

Registrants present the pro forma income statements through income (loss) from continuing operations attributable to the registrant. Discontinued operations would not be shown in the condensed historical financial statements used as the starting point for the pro forma presentation. Registrants can also elect to present an allocation of the income or loss to noncontrolling interests.

In addition, any income statement caption that is less than 15% of average net income attributable to the registrant for the most recent three fiscal years can be combined with others. When calculating average net income, a registrant excludes losses, unless it incurred losses in each of the most recent three years, in which case the average loss recorded in those years is used.

A registrant also must disclose, on the face of the pro forma income statement, basic and diluted earnings per share (EPS) from continuing operations attributable to the registrant and the number of shares used in the computation, on both a historical and pro forma basis, giving effect only to the transaction accounting adjustments and autonomous entity adjustments discussed in more detail below. The weighted average number of shares outstanding during the period should be adjusted to give effect to any shares that have been or will be issued to consummate the transaction as if the shares were outstanding as of the beginning of the period presented. The potential dilutive effect of any convertible securities issued or to be issued as part of the transaction should also be considered.

4.2.2.1 Pro forma income statement required for all fiscal years presented

As noted above, a registrant is prohibited from presenting more than one annual period in its pro forma income statements unless the transaction requiring the pro formas is accounted for as:

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

In these cases, pro forma income statements must include all annual historical financial statement periods presented in a registrant's filing.

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 this example, the subsidiary would account for the receipt of the business as a common control transaction. See our FRD publication, ***Business combinations***, for more information about accounting for common control transactions.

If a transaction that will be accounted for as a reorganization of entities under common control occurs after the date of the registrant's latest balance sheet included in a registration statement or proxy statement and post-transaction financial statements reflecting the reorganization have not been issued, pro forma income statements included in the registration statement or proxy statement are required for each fiscal year for which the registrant's historical financial statements are presented in the filing and in which the entities were under common control and any subsequent interim period, as applicable.

Refer to section 5.5.1 for a discussion of the pro forma adjustments and presentation of EPS when there is a reorganization of entities under common control.

A new registration or proxy statement filed before any financial statements of a registrant reflecting discontinued operations must include pro forma income statements for all fiscal years for which financial statements are presented and any subsequent interim period, as applicable. Likewise, a Form 8-K reporting a significant disposal that has occurred, and that has not yet been but ultimately will be reflected in the registrant's historical annual financial statements as a discontinued operation, also needs to include pro forma income statements for all fiscal years included in the registrant's prior-year annual report. Refer to our FRD publication, ***Discontinued operations***, for the criteria that must be met for reporting discontinued operations.

4.2.2.2 Pro forma information reflects common control (or discontinued operations) and other transactions

The SEC staff believes that the periods for which pro forma income statements should be presented generally should be based on the transaction that triggers the pro forma reporting requirements.

As discussed in section 4.2.2.1, pro forma income statements are required for all fiscal years for which financial statements are required if the purpose of the pro formas is to reflect a common control transaction or discontinued operation. In these cases, the common control transaction or discontinued operation would be considered the "primary" or "triggering" transaction for the pro formas.

All other transactions, regardless of whether they are related to the primary transaction (e.g., new financing to fund the common control transaction, a shared-services arrangement) or unrelated to the primary transaction (e.g., an unrelated significant acquisition), should be reflected in the pro forma income statements only for the most recent annual and subsequent interim period. Thus, the pro forma income statements for the earlier annual periods would only contain adjustments for the common control transaction or discontinued operation. That is, the pro forma combined column of the earlier annual periods should match the recasted income statements for the respective periods that the registrant expects to file in its next annual report.

Sometimes, pro formas may be voluntarily included for a common control transaction or a discontinued operation when the transaction is not significant or when it is being included as an additional transaction in pro forma financial information filed on Form 8-K (or in a proxy statement) for an unrelated transaction. In these circumstances, pro forma income statements reflecting the required transaction would be presented only for the latest annual and subsequent interim period, as applicable, rather than all periods.

For example, a registrant may be required to provide pro formas in a merger proxy to reflect a proposed business acquisition when it has had an insignificant discontinued operation transaction that has not yet been reflected in its historical financial statements. Pro forma income information is required only for the latest annual and subsequent interim period, if any. Nonetheless, the SEC staff has said that the registrant may choose to also include pro forma income statements for the earlier annual periods reflecting only the discontinued operation.

4.2.2.3 Historical results include unusual events

S-X 11-02(c)(4) requires registrants to disclose unusual events that affect the operating results presented for the most recently completed fiscal year.[9] Registrants should also 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 6.2, *Financial forecasts*.

4.2.3 Filing of a Form 10-Q or Form 10-K during the extension period

As discussed previously, the age of the pro forma financial statements to be included in a Form 8-K is determined at the earlier of the filing or due date of the initial Item 2.01 Form 8-K related to a significant acquisition. A registrant that files a Form 10-Q or Form 10-K after the initial Form 8-K has been filed and before the end of the 71-day grace period is not required to file pro forma financial information through the end of that fiscal quarter or fiscal year. When the registrant amends the Form 8-K to file pro forma information, it can provide that information through the date of either (1) the latest financial statements filed or required to be filed before the initial Form 8-K, or (2) the interim or annual financial statements filed before the amended Form 8-K.

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

If the registrant chooses the second option, and the pro forma reporting period includes the acquistion date, the registrant should avoid any doublecounting of the acquiree's operating results in the pro forma income statement. This could be accomplished by using only the acquiree stub period that ended on the acquisition date. Furthermore, when a registrant chooses the second option, it will not be required to present a pro forma balance sheet if the transaction is already reflected in the latest balance sheet filed with the SEC.

4.2.4 Combining entities with different fiscal years

The pro forma income statement must be presented based on the fiscal year of the registrant. If the registrant and an acquired business have different fiscal year ends, the following special rules apply:

- If the difference between the acquired business's year end and registrant's year end is one quarter or less, the registrant generally combines its annual income statement with that of the acquired business for the same fiscal year.
- If the difference between the acquired business's year end and the registrant's year end is more than one quarter, the registrant should use an income statement of the acquired business for a 12-month period that ends within one quarter 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.

If an interim period is required, the length of the periods presented for the registrant and the acquired business should be the same, and the periods must end not more than one quarter apart. If required, the acquired business's balance sheet should be dated at the end of its latest period included in the presentation (either annual or interim).

The periods that are being combined for both the fiscal-year and interim-period pro forma income statements must be disclosed. In addition, revenue and income must be disclosed for any periods excluded from the historical results of the acquired business or included more than once.

Illustration 4-1: Excluding interim periods or including them twice

Registrant A acquires Company B on 15 September 20X1. Registrant A's fiscal year ends on 31 December, and Company B's ends on 31 July. Company B is 30% significant to Registrant A. Registrant A must file a Form 8-K that includes pro forma income statements for the year ended 31 December 20X0 and the six months ended 30 June 20X1.

Registrant A has the following options for the historical periods of Company B to include in the pro forma income statements (assuming the periods used align with Company B's fiscal quarters):

Annual period:

Option 1: 12 months ended 31 October 20X0
Option 2: 12 months ended 31 January 20X1

Interim period:

Option 1: Six months ended 30 April 20X1
Option 2: Six months ended 31 July 20X1

Revenue and income must be disclosed for the quarter ended 31 January 20X1 if the quarter is excluded from the presentation (i.e., Registrant A uses Company B's results for the annual period ended 31 October 20X0 and the six months ended 31 July 20X1), or included twice (i.e., Registrant A uses the annual period ended 31 January 20X1 and the six months ended 30 April 20X1).

4.2.5 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 to approximate 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.

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 and 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 an acquired business are subject to the one-quarter rule (i.e., the acquired business's period end should not be more than one quarter apart from the registrant's period end). In addition, the length of the income statement period of an acquired business should be consistent with that of the registrant (i.e., the length of the period presented for the registrant and acquiree should match). The respective periods being combined should be disclosed.

Illustration 4-2: 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 25% significant to the registrant under S-X Rule 3-05. The registrant is required to file an Item 9.01 Form 8-K to include Rule 3-05 financial statements of Buymee and pro forma financial information of the combined entity. The registrant has the following options for its pro forma income statement(s):

Option 1: Using the registrant's new fiscal year

	Registrant (12 months)	Buymee
Transition period	5/1/20X2 to 12/31/20X2	1/1/20X2 to 12/31/20X2
	Plus	
Last four-month of old fiscal year	1/1/20X2 to 4/30/20X2	

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. Using this option, the length of the periods in the pro forma presentation match and end within one quarter by using the historical income statement of Buymee for its fiscal year 20X2.

Option 2: Using the registrant's old fiscal year

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

* The 12-month period of Buymee could also be (1) the 12-month period ended 31 March 20X2 (i.e., the end of its first fiscal quarter), in which case the period end dates would be within one quarter, but Buymee's results for April 20X2 would be omitted from the pro forma presentation, or (2) the 12-month period of Buymee ended 30 June 20X2, in which case the period end dates would be within one quarter, 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. If either of these alternatives are used, the additional disclosures described in section 4.2.4 must be provided.

4.2.6 Narrative disclosure only

In limited cases when there are only a few adjustments that are easy to understand, a registrant can provide a narrative description of the pro forma effects of the transaction instead of Article 11 pro formas.

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.

There are only two adjustments necessary and they are easy to understand. The registrant only needs to reclassify the noncontrolling interest within equity in the balance sheet and the income attributable to noncontrolling interest holders in the income statement.

The registrant might provide the following narrative 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 an 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 been adjusted 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.

4.3 Updating pro formas

The age of pro formas 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) 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 one, a registrant may need to update previously filed pro forma information (e.g., filed on Form 8-K). The pro forma income statements must be kept current in new or amended registration statements until the registrant is able to omit the historical financial statements of the acquired business required by Rule 3-05 from the registration statement. The pro forma balance sheet must also be updated until the transaction is reflected in the registrant's latest balance sheet filed with the SEC.

For registration statements, an FPI would follow the financial statement age requirements in Item 8 of Form 20-F.

Illustration 4-4: Updating pro formas in a registration statement

Registrant A acquires Company B on 1 June 20X1. Company B is 25% significant to Registrant A, and both are calendar year-end companies. Registrant A files a Form 8-K that includes the financial statements of Company B for the year ended 31 December 20X0 and the interim period ended 31 March 20X1. The Form 8-K also includes pro formas for the same periods.

Registrant A files a new registration statement on 1 December 20X1 that incorporates by reference the Form 8-K and Registrant A's Form 10-Q as of 30 September 20X1. Registrant A must update the pro formas in the registration statement through 30 September 20X1 to correspond with its latest interim period that is incorporated by reference.

As a result, the pre-acquisition interim results of Company B included in the pro formas would be updated in the registration statement to cover the stub period from 1 January 20X1 through 1 June 20X1 (i.e., the date of the acquisition). Registrant A should not file a pro forma balance sheet as of 30 September 20X1 because Company B is already consolidated in its Form 10-Q that is incorporated by reference.

The updated pro forma income statement would be required for any new or amended registration statement filed before Registrant A's annual audited financial statements for fiscal year 20X2 are filed with the SEC.

This contrasts with the updating requirements for Rule 3-05 financial statements because there is no requirement to update those for Company B in the registration statement since Company B's latest interim financial statements before the acquisition (i.e., 31 March 20X1) have already been filed under Item 9.01 of Form 8-K and are incorporated by reference.

However, Company B's Rule 3-05 financial statements would have to be included or incorporated by reference into every new or amended registration statement filed by Registrant A until the registrant files its annual report for 20X2 (i.e., once Company B has been included Registrant A's audited results for nine months). However, Company B's balance sheet would be omitted once Registrant A files its annual report for 20X1.

4.4 Pro forma adjustments

A registrant makes transaction accounting adjustments in order to show how a transaction would have affected the historical financial information of the registrant. Autonomous entity adjustments are used to show what a new registrant that was part of another entity would have looked like as a standalone entity (e.g., in a spin-off transaction). A registrant can also elect to present management's adjustments that provide supplemental forward-looking information.

4.4.1 Transaction accounting adjustments

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro Forma Financial Information

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

(6) The pro forma condensed balance sheet and pro forma condensed statements of comprehensive income must include, and be limited to, the following pro forma adjustments, except as noted in paragraph (a)(7) of this section:

(i) Transaction Accounting Adjustments.

(A) Adjustments that depict in the pro forma condensed balance sheet the accounting for the transaction required by US Generally Accepted Accounting Principles (US GAAP) or, as applicable, International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB). Calculate pro forma adjustments using the measurement date and method prescribed by the applicable accounting standards. For a probable transaction, calculate pro forma adjustments using, and disclose, the most recent practicable date prior to the effective date (for registration statements), qualification date (for Regulation A offering statements), or the mail date (for proxy statements).

(B) Adjustments that depict in the pro forma condensed statements of comprehensive income the effects of the pro forma balance sheet adjustments in paragraph (a)(6)(i)(A) of this section assuming those adjustments were made as of the beginning of the fiscal year presented. Such adjustments must be made whether or not the pro forma balance sheet is presented pursuant to paragraph (c)(1) of this section. If the condition in Rule 11-01(a) that is met does not have a balance sheet effect, then depict the accounting for the transaction required by US GAAP or IFRS-IASB, as applicable.

Transaction accounting adjustments are defined as those that:

- Depict in the pro forma balance sheet the accounting for the transaction required by US GAAP or IFRS-IASB
- Depict in the pro forma income statements the effects of the pro forma balance sheet adjustments, assuming those adjustments were made as of the beginning of the fiscal year presented

In an acquisition, transaction accounting adjustments should reflect the recognition of the identifiable assets acquired and liabilities assumed as prescribed by ASC 805 (i.e., the purchase price allocation). The effects of the purchase price allocation on the registrant's results after the acquisition should also be reflected (e.g., amortization of acquired intangible assets). Some provisions in the merger agreement may require transaction accounting adjustments beyond those related to the allocation. For example, a registrant might record compensation expense after the acquisition because it was required by the agreement to modify certain stock-based awards. Another example might be when a registrant records a tax benefit immediately after the acquisition because it can use the acquired deferred tax liabilities to reduce its deferred tax valuation allowance. The SEC staff has also said that accounting for transaction costs related to a business combination should be included.

In a disposal, transaction accounting adjustments should reflect the consideration received and the removal of the assets, liabilities and operations that are disposed of. The registrant would not present a line item for discontinued operations, even if the disposal qualifies as a discontinued operation (see section 4.2.2).

We believe most other items related to acquisition and disposal transactions should be evaluated under S-X 11-01(a)(8) to determine whether they are separate material transactions. Under this rule, a registrant presents pro forma financial information for "an event or transaction that has occurred or is probable for which disclosure of pro forma financial information would be material to investors" (e.g., obtaining financing to fund an acquisition, repaying debt with proceeds from a disposal). The illustrations in section 5 identify related transactions that are separately evaluated under S-X 11-01(a)(8).

Identifying items as separate material transactions under Article 11 triggers additional disclosure requirements under the amended rules. Specifically, each transaction must be described in the introductory section, and the adjustments related to such transactions must be shown separately (i.e., separate columns). See also the discussion below about the disclosures required in the introductory section and the required columnar presentation.

We believe companies should focus primarily on making sure all material aspects of a business combination or disposal are reflected in the pro forma combined amounts and that the pro forma financial information is understandable. Accordingly, we believe that a registrant could present the separate material transactions in a single column unless combining the transactions would mislead investors.

The income tax effects of the transaction accounting adjustments should also be reflected and 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.

4.4.1.1 Nonrecurring items

A registrant should make transaction accounting adjustments for nonrecurring items (i.e., revenues, expenses, gains and losses that will not recur in the income of the registrant beyond 12 months after the acquisition) and the tax effects they would have on the pro forma income statement. The SEC staff has said that transaction accounting adjustments for nonrecurring items should be made to the annual period because the acquisition is assumed to occur at the beginning of that period, and these items are typically expenses that are recognized in the historical results of the registrant shortly after the acquisition.

In addition, the explanatory notes to the pro forma presentation must identify any nonrecurring items and the related tax effects.

4.4.2 Autonomous entity adjustments

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro Forma Financial Information

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

(6) (ii) *Autonomous Entity Adjustments.* Adjustments that depict the registrant as an autonomous entity if the condition in Rule 11-01(a)(7) is met. Autonomous Entity Adjustments must be presented in a separate column from Transaction Accounting Adjustments.

Autonomous entity adjustments are only needed when a registrant was previously part of another entity and investors need to see what the registrant would have looked like as a standalone entity. These adjustments are typically required in connection with a public company's spin-off of a portion of its business to its shareholders that will report as a separate public company. In these cases, a formal agreement between the parent and the business being spun off is often established that sets forth the terms of administrative services that the parent will continue to provide to the new registrant. Adjustments may be necessary because the separate financial statements of the business being spun off may include allocations of the parent's historical expenses that do not reflect what the business will incur on a standalone basis (e.g., under an administrative services agreement). Such transactions would not qualify as transaction accounting adjustments and must be shown separately as autonomous entity adjustments.

We believe that adjustments beyond those necessary to address the allocations described above should generally be considered management's adjustments. An example would be additional costs that the newly separated company expects to incur as a public company.

4.4.3 Management's adjustments

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro Forma Financial Information

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

(7) *Management's Adjustments.* Adjustments depicting synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given may, in the registrant's discretion, be presented if in its management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction and the following conditions are met:

(i) Basis for Management's Adjustments

(A) There is a reasonable basis for each such adjustment.

(B) The adjustments are limited to the effect of such synergies and dis-synergies on the historical financial statements that form the basis for the pro forma statement of comprehensive income as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented. If such adjustments reduce expenses, the reduction must not exceed the amount of the related expense historically incurred during the pro forma period presented.

(C) The pro forma financial information reflects all Management's Adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information presented and a statement to that effect is disclosed. When synergies are presented, any related dis-synergies must also be presented.

(ii) Form of Presentation.

(A) If presented, Management's Adjustments must be presented in the explanatory notes to the pro forma financial information in the form of reconciliations of pro forma net income from continuing operations attributable to the controlling interest and the related pro forma earnings per share data specified in paragraph (a)(9) of this section to such amounts after giving effect to Management's Adjustments.

(B) Management's Adjustments included or incorporated by reference into a registration statement, proxy statement, Regulation A offering statement, or Form 8-K should be as of the most recent practicable date prior to the effective date, mail date, qualification date, or filing date as applicable, which may require that they be updated if previously provided in a Form 8-K that is appropriately incorporated by reference.

(C) If Management's Adjustments will change the number of shares or potential common shares, reflect the change within Management's Adjustments in accordance with US GAAP or IFRS-IASB, as applicable, as if the common stock or potential common stock were outstanding as of the beginning of the period presented.

(D) The explanatory notes must also include disclosure of the basis for and material limitations of each Management's Adjustment, including any material assumptions or uncertainties of such adjustment, an explanation of the method of the calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies of such adjustment.

Instruction to paragraph (a)(7). Any forward-looking information supplied is expressly covered by the safe harbor rules under Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act.

4.4.3.1 Identifying and quantifying the adjustments

Registrants have the option, but are not required, to present adjustments that include forward-looking information (i.e., synergies and related costs) related to a transaction, if management believes that such adjustments would enhance readers' understanding of the pro forma effects of the transaction.

Management must have a reasonable basis for each adjustment, and all adjustments "necessary to a fair statement of the pro forma information presented" must be included. In addition, a registrant must state in its disclosure that all such adjustments are included.

If management's adjustments reduce expenses reflected in the historical financial statements (e.g., compensation expense due to employee terminations), the reductions are limited to the amount of the related expenses that were incurred. That is, management's adjustment to reduce compensation expense for an employee expected to be terminated cannot exceed the amount recorded in the period for that employee. Any costs to achieve the savings (e.g., severance payments for terminated employees) also must be included to the extent necessary for a fair presentation.

4.4.3.2 Disclosures about each adjustment

Management's adjustments can only appear in the explanatory notes to the pro formas, and the total effect is reconciled to pro forma net income from continuing operations attributable to the registrant and the related pro forma EPS.

The explanatory notes must also include all of the following information for each adjustment:

- The basis for the adjustment and any material limitations
- Material assumptions and uncertainties
- An explanation of the method of the calculation
- The estimated time frame for achieving the synergies and realizing the related inefficiencies

4.4.3.3 Updating the disclosures

Management's adjustments should be determined as of the most recent practicable date before the filing date of a Form 8-K or the filing and effective date of a registration statement. This is similar to the obligation to update the transaction accounting adjustments for a probable acquisition.

4.4.3.4 Disclosing management's adjustments elsewhere in a filing

If a registrant presents management's adjustments outside of the pro forma presentation in a filing (e.g., MD&A), it must also disclose the amounts to which they are reconciled (i.e., pro forma net income from continuing operations attributable to the registrant and the related pro forma EPS). The registrant must also provide a cross-reference to the reconciliation.

4.5 Other content requirements

4.5.1 Introductory section

The introductory section should briefly describe each transaction reflected in the pro formas (including any transactions considered material under S-X 11-01(a)(8)), the entities involved, the periods covered by the pro formas and an explanation of what the pro forma presentation shows. It also frequently highlights the inherent limitations of the pro formas. For example, it often states that the pro forma financial information may not reflect the financial condition or operating results of a combined or reorganized entity or may not be useful in predicting its future condition and operating results.

Illustration 4-5: Example of introductory section

The following unaudited pro forma condensed combined financial statements are based on our historical consolidated financial statements and Company B's historical consolidated financial statements as adjusted to give effect to the 20 August 20X4 acquisition of Company B. 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 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 Company B as if it had occurred on that day.

The transaction accounting adjustments for the acquisition consist of those necessary to account for the acquisition. Separately, the Company will issue approximately $72.5 million in 4.5% fixed-rate debt with debt issuance cost of $2.5 million, a portion of which will be used to fund the acquisition. The adjustments related to the issuance of this debt are shown in a separate column as "other transaction accounting adjustments."

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 and the related financing 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. Our actual financial condition and results of operations may differ significantly from the pro forma amounts reflected herein due to a variety of factors.

4.5.2 Columnar presentation

The pro forma balance sheet and income statement(s) must include a separate column for the historical financial information of the registrant and, if applicable, historical information of other entities involved in a transaction such as an acquired business. The transaction accounting adjustments should also be shown as a separate column in both statements in addition to the combined total. Transaction accounting adjustments for any related transactions considered material under S-X 11-01(a)(8) will require the inclusion of at least one additional adjustment column (see section 4.4.1 for further discussion).

When applicable, autonomous entity adjustments must also be shown separately.

The following illustration shows this columnar presentation for the most recent fiscal year of a registrant that acquired a business (Company X):

Illustration 4-6: Presentation example

Unaudited Pro Forma Condensed Combined Statements of Operations

Year Ended 31 December 20X3

(In thousands, except per-share information)

	Registrant historical	Company X historical	Transaction accounting adjustments	Notes	Other transaction accounting 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	(a)			26,300
Selling, general and administrative expense	33,000	21,900	–				54,900
Operating income	13,600	3,100	(2,400)				14,300
Interest income (expense)	1,600	–			(3,400)	(c)	(1,800)
Income before income taxes	15,200	3,100	(2,400)		(3,400)		12,500
Income tax provision (benefit)	4,500	1,100	(504)	(b)	(714)	(d)	4,382
Net income	$ 10,700	$ 2,000	$ (1,896)		(2,686)		$ 8,118
Basic and diluted earnings per share	$ 1.09						$ 0.83
Weighted average shares	9,800						9,800

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

4.5.3 Explanatory notes

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro forma financial information

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

(11) The accompanying explanatory notes must disclose:

(i) Revenues, expenses, gains and losses and related tax effects which will not recur in the income of the registrant beyond 12 months after the transaction.

(ii) For Transaction Accounting Adjustments:

(A) A table showing the total consideration transferred or received including its components and how they were measured. If total consideration includes contingent consideration, describe the arrangement(s), the basis for determining the amount of payment(s) or receipt(s), and an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why; and

(B) The following information when the accounting is incomplete: a prominent statement to this effect; the items for which the accounting depicted is incomplete; a description of the information that the registrant requires, including, if material, the uncertainties affecting the pro forma financial information and the possible consequences of their resolution; an indication of when the accounting is expected to be finalized; and other available information that will enable a reader to understand the magnitude of any potential adjustments to the measurements depicted.

(iii) For each Autonomous Entity Adjustment, a description of the adjustment (including the material uncertainties), the material assumptions, the calculation of the adjustment, and additional qualitative information about the Autonomous Entity Adjustments, if any, necessary to give a fair and balanced presentation of the pro forma financial information.

Generally, each adjustment shown in the pro forma balance sheet and income statement(s) should be accompanied by an explanatory note that clearly explains its basis and any assumptions used in calculating it. Additional disclosures are required when any accounting for a transaction is incomplete, and there are specific disclosures required about the consideration paid or received in acquisition and disposal transactions. In addition, nonrecurring items (see section 4.4.1.1) should be disclosed in the explanatory notes. The illustrations in section 5, Pro forma adjustment illustrations, show explanatory note disclosures for common adjustments made in a variety of transactions requiring Article 11 pro formas.

In addition, the effect of any unusual events on the results of operations for the most recent fiscal year (see section 4.2.2.3) can be disclosed as part of the explanatory notes.

4.6 Specific or unique circumstances

4.6.1 Pro formas involving multiple transactions

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro Forma Financial Information

Rule 11-02(b), Preparation requirements, Implementation guidance

(4) *Multiple transactions.*

(i) When consummation of more than one transaction has occurred, or is probable, the pro forma financial information must present in separate columns each transaction for which pro forma presentation is required by Regulation S-X Rule 11-01.

(ii) 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.

As discussed in section 4.4.1, a registrant may need to separately evaluate certain transactions that are related to, for example, an acquisition to determine whether they require separate disclosure under S-X Rule 11-01(a)(8). There are also situations where multiple separate transactions requiring pro formas have occurred during a fiscal year or will be probable (e.g., two or more business acquisitions). Generally, these transactions should be presented in the same pro forma presentation but with separate columns showing the effects of each.

In some circumstances, a registrant may be required to present pro formas for both a previous transaction and a proposed transaction in a merger proxy statement or registration statement. In this case, the pro forma information should have separate columns for the proposed transaction subject to

the merger proxy or registration statement and for the previous transaction. The presentation should also include a subtotal column that shows the effects of the previous transaction and serves as the starting point for the proposed transaction.

If the merger proxy or registration statement incorporates by reference pro formas reflecting the previous transaction (e.g., from a previously filed Form 8-K), the registrant may carry forward the pro forma information as the starting point when presenting the pro formas 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 section provide sufficient disclosure about the nature of the multiple transactions reflected and how those transactions are reflected in the pro formas.

Illustration 4-7: Multiple unrelated 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 a separate 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	Transaction accounting adjustments (acquisition of Acquiree B)	Pro forma financial information (adjusted for acquisition of Acquiree B)	Acquiree A historical financial statements	Transaction accounting 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 information (adjusted for acquisition of Acquiree B)	Acquiree A historical financial statements	Transaction accounting adjustments (acquisition of Acquiree A)	Pro forma results (combined)

4.6.2 Transactions with range of possible results

Excerpt from SEC rules and regulations

Regulation S-X, Article 11 Pro Forma Financial Information

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

(10) If the transaction is structured in such a manner that significantly different results may occur, provide additional pro forma presentations 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 different 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), a range of possible redemption scenarios in transactions involving the acquisition of a target company by a special purpose acquisition company or to reflect variability in the purchase price for a proposed acquisition. Additional pro formas may include:

- An 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 formas, particularly if the varying outcomes would affect the accounting for the transaction

Illustration 4-8: 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 application of the equity method of accounting, the registrant would present separate pro forma financial information 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 in both the pro forma balance sheet and income statements:

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

	Assuming 100% of shares acquired			Assuming 20% of shares acquired	
Registrant historical financial statements	Company A historical financial statements	Transaction accounting adjustments (acquisition of Company A)	Pro forma results (combined)	Transaction accounting 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 information. See Illustration 5-1 for an example of a sensitivity analysis disclosure related to a business combination.

4.6.3 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 formas 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 formas 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 acquired business 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. These requirements are in Item 8 of Form 20-F and can be applied, if the SEC staff grants permission, by an acquired business that would qualify as an FPI if it were a registrant but doesn't meet the definition of a foreign business. When a registrant acquires a foreign target that can use these age requirements, the interim Rule 3-05 financial statements may only need to cover the first six months of the year.[10] These financial statements may not align with a registrant's financial statements that have been filed or are required to be filed and the pro formas 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 registrant acquires a foreign business that is significant at the 25% level under S-X Rule 3-05 and files the audited financial statements of the calendar year-end foreign target as of and for the year ended 31 December 20X0 in an Item 9.01 Form 8-K. Although interim financial statements are not required in the Rule 3-05 financial statements, the pro formas in the Form 8-K must include the three months ended 31 March 20X1 based on the most recent financial statements of the registrant.

Likewise, when an FPI acquires a US domestic target company, the 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 formas would still be based on the FPI's latest financial statements included in the filing.

As discussed in section 4.2.4, the pro forma rules allow for a difference of up to one quarter between the fiscal year end of the registrant and the fiscal year end of the target. If there is a difference of more than one quarter, the target's historical financial information in the pro formas will need to be updated to a period ending within one quarter of the registrant's year end.

[10] See Item 8.A.5 of Form 20-F when determining the requirement to include interim financial statements. 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.

5 Pro forma adjustment illustrations

This section provides examples of transaction accounting adjustments, autonomous entity adjustments and management's adjustments that may be presented to give effect to certain events and circumstances described in section 2. Each illustration in this section shows only the adjustments contemplated by the respective example.

5.1 Business combinations

This section describes common transaction accounting adjustments that may be required to give effect to the acquisition of a business that is accounted for as a business combination under ASC 805. The illustrations below include transaction accounting adjustments for the acquisition as well as other transaction accounting adjustments for material transactions under S-X 11-01(a)(8).

See our FRD publication, ***Business combinations***, for additional discussion about the accounting described below. For more information about accounting for an asset acquisition, see our Technical Line, ***A closer look at the accounting for asset acquisitions***.

5.1.1 Calculation of purchase price

As noted above, the explanatory notes must include a table showing how the total purchase price was calculated. The table should include the value of any noncash consideration (e.g., stock).

When calculating the value of stock to be issued in a probable acquisition, registrants should use a stock price as of the most recent practicable date before the filing date or effective date of a registration statement. In addition, the explanatory notes to the pro forma balance sheet should disclose the date used and include a sensitivity analysis for the range of possible outcomes based on reasonably likely increases and decreases in the stock price.

The following illustration shows the pro forma disclosures a registrant might provide for an estimated purchase price for a probable acquisition in a registration statement filed on 17 August 20X5.

Illustration 5-1: Schedule and disclosures of estimated purchase price calculation

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.

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 and the exchange ratio):

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 31 July 20X5.

The equity portion of the purchase price will depend on the market price of the Company's common shares when the acquisition is consummated. The Company believes that a 10% fluctuation in the market price of its common stock is reasonably possible based on historical volatility, and the potential effect on purchase price would be:

	Company's share price	Purchase price (equity portion)
As presented	$ 28.35	$ 185,806
10% increase	31.19	204,419
10% decrease	25.52	167,258

5.1.2 Contingent consideration

ASC 805 requires a registrant 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. The explanatory notes must describe the arrangement, the basis for determining the amount of payments and an undiscounted estimate of the range of outcomes. If a range cannot be estimated, that fact and the reasons why must be disclosed.

Contingent consideration classified as a liability in a registrant's balance sheet is remeasured at fair value through net income at the end of each reporting period. Therefore, if the pro formas filed after consummation of an acquisition must be updated for a more recent period, no adjustment should be made to reflect changes in the fair value of contingent consideration, because those changes would be recognized by the registrant in its historical post-acquisition results.

5.1.3 Preliminary purchase price allocation

Registrants often have to present pro formas before the purchase price allocation is finalized. When this happens, a prominent statement of that fact must be disclosed in the explanatory notes along with all of the following:

- The items for which the accounting is incomplete
- A description of the information that the registrant needs, including, if material, the uncertainties affecting the pro formas and the possible consequences of their resolution
- An indication of when the accounting is expected to be finalized
- Other available information that will enable a reader to understand the magnitude of any potential future adjustments to the accounting

The preliminary purchase price reflected in the pro formas should include 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. There is no obligation to update the pro formas at a future date when the allocation is finalized.

The following example shows pro forma disclosures a registrant might provide to explain the preliminary nature of an acquirer's purchase price allocation.

Illustration 5-2: 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 the transaction accounting 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 as described in more detail in the explanatory notes below. The final allocation is expected to be completed when the Company files its report on Form 10-Q for the quarter ended 30 September 20X5 and could differ materially from the preliminary allocation used in the transaction accounting 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.

5.1.4 Debt

5.1.4.1 Acquired business's debt assumed by the registrant

If a registrant assumes an acquired business's debt, the registrant would include transaction accounting adjustments for the acquisition to measure the debt at fair value and amortize the remeasurement adjustment over the remaining life of the debt.

Additional financing transactions entered into to pay for the acquisition or refinance debt issued by the acquired business would be considered other transaction accounting adjustments and are described in more detail below.

5.1.4.2 Additional debt financing

If additional financing is necessary to complete an acquisition, other transaction accounting adjustments must be presented separately from the transaction accounting adjustments for the acquisition if the financing transactions are considered material. These adjustments should reflect the interest expense associated with the financing and any debt issuance costs and related amortization. The details of the transactions should be disclosed in the explanatory notes. Registrants may need to make certain assumptions about interest rates to make these adjustments to the pro forma income statements. Interest expense adjustments for fixed-rate debt generally should reflect the rate in effect at the time a financing commitment was obtained or an estimated interest rate based on the index used 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 other transaction accounting adjustment should be calculated using a current interest rate (e.g., based on the index at the time of, or reasonably close to, the filing date), and the registrant should disclose the effect on pro forma net income of a 1/8 of a percentage point change in interest rates.[11]

5.1.4.3 Obtaining new debt and refinancing acquiree debt to complete acquisition

A registrant may obtain financing to pay for an acquisition and simultaneously refinance the existing debt of an acquired business.

Illustration 5-3: Additional debt financing and refinancing debt of the acquired business

When its acquisition of Target XYZ closes, Registrant A will issue approximately $72.5 million in 4.5% fixed-rate debt with debt issuance cost of $2.5 million, a portion of which will be used to fund the acquisition for approximately $62.5 million. Registrant A also will extinguish Target XYZ's existing debt of approximately $7.3 million, which includes a prepayment penalty. Registrant A will not legally assume Target XYZ's outstanding debt.

The registrant might present the following pro forma disclosures, assuming that changes in debt, debt issuance costs and interest expense are the only transaction accounting adjustments (in thousands):

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

Unaudited Pro Forma Condensed Combined Financial Information
As of and for the six months ended 30 June 20X5

	Registrant historical		Target XYZ (Acquiree) historical		Other transaction accounting 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.

Notes to Unaudited Pro Forma Condensed Combined Financial Information

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

Decrease for extinguishment of XYZ's existing debt	(7,300)
Increase for issuance of new debt	70,000
Other transaction accounting 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 the extinguishment of XYZ's 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 XYZ's debt	$	(188)	$	-
Interest expense on new 4.5% debt		1,631		3,263
Amortization of new debt issuance costs		125		250
Other transaction accounting adjustments to interest expense	**$**	**1,568**	**$**	**3,513**

5.1.4.4 Bridge loan financing

If long-term financing is needed but not in place when an acquisition is consummated, a registrant may use a short-term bridge loan to pay for the acquisition. Such financing, if material, should be reflected in the pro forma balance sheet and income statements as other transaction accounting adjustments to interest expense (including any amortization of debt issuance cost). These loans typically are replaced with permanent financing at or before the end of their term, and the short-term and permanent financing together mean that the interest expense and amortization of debt issuance costs do not need to be identified as a nonrecurring item.

Illustration 5-4: Bridge loan financing

Registrant A obtained short-term bridge financing of $63 million, with debt issuance costs of $2.52 million, just before the closing date of 24 August 20X5. The interest on this loan is based on a one-month benchmark rate (e.g., Secured Overnight Financing Rate) plus certain margins. ABC Corp (acquired business) had no debt outstanding as of the acquisition date.

Registrant A might provide the following pro forma disclosures, assuming that changes in short-term debt, debt issuance costs and interest expense are the only transaction accounting adjustments (in thousands):

Unaudited Pro Forma Condensed Combined Financial Information

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

	Registrant historical	ABC Corp historical	Other transaction accounting 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. The Company expects to replace this loan with long-term financing at or before maturity.

(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 this pro forma financial information is 2.28%. This rate is the one-month benchmark rate of 0.28% on 24 August 20X5, plus the margins specified in the bridge facility agreement.

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
Other transaction accounting adjustments to interest expense	**$ 1,978**	**$ 3,956**

A 1/8 of a percentage point increase or decrease in the benchmark rate would result in a change in interest expense of approximately $0.05 million for the six months ended 30 June 20X5 and approximately $0.1 million for the year ended 31 December 20X4.

Although the term of the bridge loan is less than one year in this example, it is assumed that the bridge loan will be replaced by permanent financing. As a result, 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 presented, and this item is not identified as nonrecurring.

5.1.5 Intangible assets

The transaction accounting adjustments should 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 recorded by the acquired business and to reflect the goodwill in the preliminary purchase price allocation. The SEC staff previously expressed a view that impairment charges recognized in the acquired business's historical income statements should not be eliminated. However, we have observed diversity in practice and the SEC staff has not always objected to registrants removing impairment charges.

In each of the pro forma income statement periods, the individual fair values as of the actual or assumed acquisition 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. And it may be necessary to provide sensitivity ranges to state the variability in amortization expense if the fair value estimates for the intangible assets are preliminary.

The expected useful lives of material intangible assets acquired should be disclosed in the explanatory notes. If the identified intangible assets are not amortized on a straight-line basis, the effect on operating results for the five years after the acquisition should be disclosed if it's material.

Illustration 5-5: Intangible assets and amortization expense

Registrant A has preliminarily identified and valued approximately $104.6 million in intangible assets acquired in its acquisition of ABC Corp 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.

Registrant A might provide the following pro forma disclosures, assuming that changes in its intangible assets, goodwill and amortization expense are the only transaction accounting 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 historical	Transaction accounting 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

	Registrant historical	ABC Corp historical	Transaction accounting adjustments	Notes	Pro forma combined
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	6,750	3,375
Trade names	28,300	7	4,043	2,021
Customer relationships	8,840	5	1,768	884
	$ 104,640		12,561	6,280
Historical amortization expense			(4,438)	(2,219)
Transaction accounting adjustments to amortization			**$ 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 fair value of each intangible asset as of the actual or assumed purchase date is 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.

5.1.6 Long-lived tangible assets

The disclosure considerations for transaction accounting adjustments related to acquired tangible assets are very similar in nature to those discussed above for intangible assets.

Transaction accounting adjustments should be made to reflect the adjustment of an acquired business'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 material PP&E acquired should be disclosed in an explanatory note.

Sensitivity ranges to address potential variability in depreciation expense may be necessary if the fair value used for PP&E is preliminary. In practice, registrants sometimes use the acquired business's carrying values because the registrant may not know the fair value when the pro formas are prepared. In this situation, the registrant shouldn't state that the carrying value approximates fair value unless it has a sufficient basis for that statement. Instead, the registrant should indicate that it has not yet determined the fair value of PP&E acquired and is using the carrying value.

5.1.7 Transaction costs

A registrant typically incurs various acquisition-related costs in connection with a business combination. Under ASC 805, costs related to the transaction (e.g., costs of services of lawyers, investment bankers, accountants) are not part of the allocation of the consideration transferred. These costs are expensed in the periods in which costs are incurred and the services are received. However, as noted above, the SEC staff has stated that adjustments related to transaction costs are part of the transaction accounting adjustments for the acquisition rather than for separate material transactions.

Making transaction accounting adjustments for a business combination's transaction costs generally depends on whether the transaction costs are recognized in the registrant's or the acquired business's historical income statement. Transaction costs that are already recognized in the historical financial statements should not be eliminated using transaction accounting adjustments. Adjustments should only be made for transaction costs that have been incurred or are expected to be incurred that have not been recognized.

Illustration 5-6: Transaction costs not yet recognized in the historical financial statements

Registrant A incurred $2.5 million of transaction costs related to a business combination, and this amount is recognized in its historical financial statements for the six-month period ended 30 June 20X5. In addition, XYZ Company (acquired business) incurred an additional $1 million in the month ended 31 July 20X5 that it has not yet paid.

Because the initial $2.5 million of transaction costs are already reflected in Registrant A's historical income statement, no adjustment is necessary for that amount. However, a transaction accounting adjustment should be made in the annual period ended 31 December 20X4 to recognize the additional $1 million of transaction costs incurred by XYZ Company. The registrant might provide the following pro forma disclosures, assuming that the effect of transaction costs is the only transaction accounting adjustment affecting these line items (in thousands):

Unaudited Pro Forma Condensed Combined Financial Information
As of 30 June 20X5

	Registrant historical	XYZ Company historical	Transaction accounting adjustments	Notes	Pro forma combined
Accrued liabilities	$ 3,000	$ 500	$ 1,000	(a)	$ 4,500
For the year ended 31 December 20X4					
General and administrative expenses	25,000	2,000	1,000	(a)	28,000

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) Represents the accrual of additional transaction costs incurred by XYZ Company subsequent to 30 June 20X5. The remaining transaction costs of $2.5 million are included in the historical income statement of the Company for the six months ended 30 June 20X5. These costs will not affect the Company's income statement beyond 12 months after the acquisition date.

5.1.8 Gains and losses attributable to the acquisition

An acquirer may incur certain gains or losses 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 and included as transaction accounting adjustments for the acquisition. Other gains or losses may be recognized as part of other transaction adjustments, if the underlying transactions are material under S-X Rule 11-01(a)(8). These might include gains/losses recognized from the settlement or termination of preexisting 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).

5.1.9 Inventory valuation

Acquired inventory balances are recognized in a business combination at fair value under ASC 820, *Fair Value Measurement*. Accordingly, the transaction accounting adjustments should be used to step up the pro forma balance sheet to reflect the fair value consistent with the purchase price allocation and to reflect in the pro forma income statement the amortization of the step-up based on how long it will take to sell the inventory.

The following illustration shows a disclosure that a registrant might provide for a transaction accounting adjustment to inventory in the pro forma balance sheet to reflect the fair value adjustment based on the purchase price allocation.

Illustration 5-7: Inventory valuation adjustment

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) The adjustment steps up the pro forma balance sheet for Target XYZ's finished goods and work-in-process inventory to a fair value of approximately $9 million. The calculation of fair value 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. The pro forma income statement for the year ended 31 December 20X4 is also adjusted to increase cost of sales by the same amount as the inventory that is expected to be sold within one year of the acquisition date.

5.1.10 Assumed liabilities for performance obligation

In a business combination that occurs after an entity adopts ASC 606, the acquiring entity recognizes a contract liability (e.g., deferred revenue) related to the performance obligations that it assumes if the acquired entity has received consideration (or the amount is due) from the customer. We believe the acquirer should apply the definition of a performance obligation in ASC 606 to determine whether it has assumed a performance obligation.

Under ASC 606, a performance obligation may be created based on a customer's reasonable expectations and may include promises that are implied by an entity's customary business practices or industry norms. See our FRD publication, ***Revenue from contracts with customers (ASC 606)***, for additional guidance on identifying performance obligations in a contract with a customer. If a contract liability for an assumed performance obligation is recognized, the acquirer derecognizes the contract liability and recognizes revenue in the statement of operations as it provides those goods or services after the acquisition date.

An assumed performance obligation is measured at fair value at the date of acquisition, pursuant to the guidance in ASC 820. Therefore, in certain situations, the registrant may write off a portion or the entire deferred revenue balance of the acquired business and reflect the corresponding transaction accounting adjustment in both the pro forma balance sheet and pro forma income statement.

Illustration 5-8: Deferred revenue adjustment

A calendar-year registrant acquires Target XYZ on 25 August 20X5 and is filing pro formas for the significant business combination on Form 8-K. As of the acquisition date, Target XYZ had deferred revenue of approximately $35 million related to remaining services in various extended maintenance arrangements that were entered at different points in time. The registrant determines that it has assumed performance obligations under these agreements, and the fair value of the assumed obligation calculated pursuant to ASC 820 is approximately $20 million.

The registrant might make the following pro forma disclosures related to the transaction accounting adjustments for deferred revenue (in thousands):

Unaudited Pro Forma Condensed Combined Financial Information

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

	Registrant historical	Target XYZ historical	Transaction accounting 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 performance obligations to a fair value of approximately $20 million, a reduction of $15 million from the carrying value. 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 reduce revenue related to the assumed performance obligations as the maintenance services are provided over the respective remaining periods of the agreements. The transaction accounting 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 transaction accounting adjustments to revenue by estimating the reduction arising from the difference between prepayment related to each extended maintenance arrangement and the fair value of the assumed performance obligations as they are satisfied over the original expected service period. That results in an estimated reduction of $8.9 million for the next 12 months and $3.5 million for the following six months.

5.1.11 In-process research and development

Under ASC 805, acquired in-process research and development (IPR&D) assets cannot 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 business incurred R&D expenses in its pre-acquisition historical financial statements. The SEC staff has said that a registrant should not eliminate the R&D expense recognized in the acquired business's historical financial statements.[12]

5.1.12 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 business's deferred tax assets.

For example, a registrant that has previously recorded a valuation allowance on its deferred tax assets may reverse that allowance because it can use the deferred tax liabilities assumed in a business combination to offset the reversal of its preexisting deferred tax assets. Changes in the acquirer's valuation allowance that result from a business combination should be recognized in the acquirer's deferred income tax expense (benefit) during the reporting period that includes the business combination. On the other hand, changes to the acquired business's valuation allowance are accounted for as part of the allocation of the purchase price.

[12] SEC staff's Financial Reporting Manual Section 3250.1.g.

The registrant should consider the effects of the business combination on its or the acquired business's previously recorded valuation allowances and determine whether transaction accounting adjustments for the acquisition related to changes to the valuation allowances are necessary. Such adjustments may include:

- A reduction of the registrant's or acquired entity's valuation allowance in the pro forma balance sheet
- A reduction of the valuation allowance on the registrant's deferred tax assets as a result of the acquisition in the pro forma income statement (with disclosure that the income tax benefit related to the reduction of its valuation allowance is nonrecurring)
- An adjustment to the pro forma income statement to reflect the effect of the transaction on the combined entity's pro forma income tax provision or benefit (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)

After a business combination, the combined entity could have an effective tax rate that differs from the registrant's historical tax rate. The registrant would need to consider whether its historical tax rate should be revised when calculating the pro forma effects of the business combination.

Illustration 5-9: Change in registrant's valuation allowance

After considering all available evidence, Registrant A, a calendar-year registrant, 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, Registrant A acquired ABC Company, and the acquisition resulted in a deferred tax liability balance of $60,000 related primarily to acquired intangible assets that it will amortize for financial reporting purposes. After the acquisition, Registrant A 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 preexisting deferred tax assets. Accordingly, Registrant A recorded a tax benefit of $30,000 related to the reversal of its valuation allowance in the period the acquisition occurred.

Registrant A might provide the following pro forma disclosures related to the ABC acquisition, assuming that changes in the registrant's valuation allowance are the only transaction accounting 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 historical	Transaction accounting adjustments	Notes	Pro forma combined
Deferred income tax assets (liabilities)	$ -	$ 20,000	$ (50,000)	(a)	$ (30,000)
(Loss) income before income taxes	(10,000)	15,000			5,000
Income tax (benefit) provision	-	3,750	(30,000) (2,500)	(a) (b)	(28,750)
Net (loss) income	$ (10,000)	$ 11,250	$ 32,500		$ 33,750

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) This adjustment reflects (1) the purchase accounting adjustments to the acquired business's historical deferred tax asset of $20,000 to the deferred tax liability balance of $60,000 (a net change of $80,000), and (2) the elimination of the Company's deferred tax asset valuation allowance of $30,000. This results in a net deferred tax liability balance of $30,000 for the pro forma combined entity. 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. The income tax benefit of $30,000 related to the reduction in the Company's valuation allowance is also reflected in the pro forma income statement as a nonrecurring adjustment to income from continuing operations.

(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 would have benefited from the Company's historical pretax losses in the pro forma period presented. This transaction accounting 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 25% and calculated as follows.

Pro forma combined income before income taxes	$	5,000
Statutory tax rate		25%
Pro forma combined income tax provision		1,250
Historical combined income tax provision		3,750
Transaction accounting adjustment		**(2,500)**

5.1.13 Compensation arrangements

In connection with business combinations, acquired businesses' 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. In general, the effects of settlements and exchanges resulting from preexisting contractual provisions or that are required by the merger agreement should be reflected in the transaction accounting adjustments for the acquisition. Otherwise, settlements and exchanges should be evaluated as separate transactions under S-X 11-01(a)(8).

5.1.13.1 Change-in-control provisions

Change-in-control provisions in employment or compensation agreements may cause the acceleration of share-based awards or one-time cash payments upon consummation of an acquisition. Compensation charges resulting from these provisions may be included in the acquired business's pre-acquisition or acquirer's post-acquisition financial statements, depending on the facts and circumstances.

For example, if the preexisting terms of the acquired business' share-based awards contained a change-in-control provision that automatically accelerated all unvested awards immediately upon consummation of the acquisition, the resulting compensation charges would be recognized in the acquired business's pre-acquisition financial statements. If the charges are not yet recognized in the periods presented in the pro formas, the registrant would make transaction accounting adjustments for the acquisition to reflect them. But, if a change-in-control provision is added to an acquired business' share-based awards in

contemplation of the business combination, the registrant generally would expense the cost in its financial statements following the acquisition,[13] and it should evaluate the new provision as a separate transaction under S-X 11-02(a)(8).

The SEC staff has said that a registrant generally should not make transaction accounting adjustments to remove any historical compensation expense of the acquired entity.

Illustration 5-10: Change-in-control provisions

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. The provision is triggered if both of the following events occur: a change-in-control and a termination or reduction in the responsibilities of the executives. The registrant decided to terminate these executives immediately following the business combination, so both conditions were met. Because the registrant elected to terminate the executives, the post-combination compensation expense that it will recognize should be reflected as other transaction accounting adjustments.

Share-based compensation awards

Target XYZ also decided to modify its share-based awards to include a change-in-control provision in contemplation of its acquisition by the registrant. To ease the transition for Target XYZ's employees, the registrant agreed to the modification to these awards as part of its negotiations. As a result, the registrant will recognize a compensation charge immediately after the business combination that should be reflected in other transaction accounting adjustments.

The registrant concluded that the execution of these new compensation arrangements was material under S-X 11-01(a)(8) and might make the following pro forma disclosures:

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) The Company expects to record a one-time post-combination expense of $5 million consisting of severance and other separation benefits in connection with the termination of certain executive officers of Target XYZ. The executives' employment agreements included double-trigger provisions that require us to provide these benefits upon a change in control and termination. The amount is accrued in the pro forma condensed balance sheet and reflected as an expense in the pro forma condensed statement of operations for the year ended 31 December 20X4.

(b) The Company expects to record a one-time post-combination compensation expense of $7 million related to the decision to accelerate the unvested share-based awards of Target XYZ in contemplation of the merger. This amount is reflected in the pro forma condensed statement of operations for the year ended 31 December 20X4 and as a reduction to retained earnings in the pro forma condensed balance sheet.

[13] 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 acquired business's 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 post-combination compensation cost).

5.1.13.2 New or replacement compensation agreements

Generally, new compensation contracts with employees of the acquired business that are stipulated in the merger agreement would require transaction accounting adjustments for the acquisition. Otherwise, the new contracts should be evaluated under S-X 11-01(a)(8).

Illustration 5-11: New compensation arrangements

While negotiating an acquisition of Target XYZ, the registrant decided to execute new compensation arrangements with five key executives of Target XYZ who will continue as employees of the registrant. These compensation agreements were not contemplated in the merger agreement and result in annual salary increases and one-time bonuses (cash as well as fully vested restricted stock units).

The registrant also decided to issue 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 material under S-X 11-01(a)(8) and might make the following pro forma disclosures:

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. In addition, this adjustment includes $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.

(b) The 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 from two to three years.

5.1.14 Accounting policies and financial statement presentation

Conforming the accounting policies of the acquired business to those of the registrant are considered transaction accounting adjustments for the acquisition (e.g., when the entities use different methods for inventory accounting, when the registrant has already adopted a new accounting principle that the acquired business has not). In addition, the registrant may need to reclassify balance sheet and income statement items to conform the historical financial statement presentation of the acquired business to its own. These are also related to the acquisition, and the following illustration shows examples of these adjustments.

Illustration 5-12: Conforming accounting policies and classification

Unaudited Pro Forma Condensed Combined Financial Information

For the year ended 31 December 20X4

	Registrant historical	Target XYZ historical	Transaction accounting adjustments	Notes	Pro forma combined
Revenues	$ 120,500	$ 48,000	$ –		$ 168,500
			(3,000)	3(a)	
Cost of revenues	63,000	24,500	2,500	4(a)	87,000
Selling and administrative expenses	11,500	10,000	(2,500)	4(a)	19,000

Notes to Unaudited Pro Forma Condensed Combined Financial Information

Note 3 Accounting policy 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 transaction accounting 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.

We believe that registrants can combine the reclassification adjustments with the remaining transaction accounting adjustments for the acquisition as shown above or show them in a separate column, provided the disclosure is clear and understandable.

When the registrant adopts a new accounting principle, the effects on the pro formas are considered transaction accounting adjustments for the acquisition. A registrant is prohibited from adopting a new accounting principle in the pro forma presentation until it has filed financial statements reflecting the adoption. Instead, the potential effects of the recently issued accounting standard should be described in accordance with Staff Accounting Bulletin (SAB) Topic 11.M.

The following illustration shows how a registrant would reflect the adoption of a new accounting principle in two different situations:

Illustration 5-13: Adoption of new accounting principles

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

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

Analysis:

Registrant A is not allowed to make transaction accounting adjustments to reflect the pro forma effects of the new accounting principle for the year ended 31 December 20X4. However, the registrant should make adjustments to conform the other accounting policies of Target XYZ to its own policies. In addition, the registrant should include or reference in the explanatory notes the disclosures required by SAB Topic 11.M.

Example 2: New accounting principle reflected in interim financial statements

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

Analysis:

Because Target ABC has not reflected the new accounting principle in its interim financial statements, Registrant B should include transaction accounting adjustments for the acquisition to conform Target ABC's interim period to the registrant's policy.

Assuming that the accounting principles of Registrant B and Target ABC are consistent for the year ended 31 December 20X4, the registrant would not make any transaction accounting adjustments to reflect the new accounting principle in that period because it has not yet reissued historical financial statements for the annual period reflecting the accounting change. In that case, the explanatory notes should clearly explain how the annual and interim periods are different due to the new accounting principle.

An acquired business does not always have to adopt a new accounting standard adopted by the registrant in its Rule 3-05 financial statements. However, as shown in the illustrations, the analysis is different for pro formas, and it can be challenging to alter the existing adoption plans of an acquired business.

We recommend that a registrant contact the SEC staff and seek relief from this requirement if adopting a new principle solely for the purpose of a pro forma presentation would require significant resources and/or could compromise the timing of the transaction.

5.1.15 Business combinations involving foreign entities

5.1.15.1 Basis of accounting

The pro formas should generally reflect the basis of accounting used by the registrant. When a domestic registrant acquires a business that applies a different basis of accounting, transaction accounting adjustments for the acquisition are required to convert the acquired business'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. While the registrant may not be required to reconcile the acquiree's financial statements to US GAAP (e.g., if they are 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.

- An FPI 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's financial statements to IFRS in the pro forma financial information.
- An FPI 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 the 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.[14]

In addition, if a registrant acquires another company in a transaction accounted for as a reverse acquisition, the post-acquisition financial statements will generally be those of the legal acquiree, and the acquiree's basis of accounting 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-IASB may acquire a US target (i.e., accounting acquirer and legal acquiree) that reports under US GAAP. In these situations, 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.

We believe that registrants can combine the adjustments that give effect to the conversion of the acquired foreign business's balance sheet and income statement to US GAAP (or the registrant's basis of accounting) with the remaining transaction accounting adjustments for an acquisition or show them in a separate column, provided the disclosure is clear and understandable.

5.1.15.2 Foreign currency adjustments

S-X Rule 3-20, *Currency for financial statements for foreign private issuers*, allows an FPI to prepare its financial statements in the currency it believes is appropriate, but the rule does not address financial statements of acquired businesses. The SEC staff allows these financial statements to 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.

However, all the columns in the pro formas should be presented using the reporting currency of the registrant. 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 schedule in the explanatory notes.

Illustration 5-14: Basis of accounting and foreign currency adjustments

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.

However, in the pro forma financial information, the registrant must make transaction accounting adjustments to translate the target's financial information to its reporting currency of US dollars and to convert the target's financial information to US GAAP.

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

The following example is an acceptable presentation of the registrant's pro forma financial information related to the foreign business acquisition. In this example, the registrant elects to present the adjustments to conform accounting policies with the remaining transaction accounting adjustments for the 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)	Transaction accounting 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-IASB 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 transaction accounting adjustments convert Target XYZ's financial information from IFRS-IASB to US GAAP and align Target XYZ's accounting policies with 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.

5.1.16 Regulatory effects of a business combination

The SEC staff has said that regulatory effects of a transaction should be evaluated under Regulation S-X Rule 11-01(a)(8) and included in the presentation, if material. Examples include deposit fee caps and additional regulatory costs following the merger of two banks.

A registrant or its target may also expect to dispose of certain operations to gain approval for the business combination from one or more regulatory agencies. If the disposal is probable and material at the time the pro formas are filed, it should be reflected as part of the other transaction adjustments. If uncertainties remain about which operations may be disposed of, the registrant should disclose the uncertainties and the possible consequences of their resolution. We believe that a registrant should consider the status of its discussions with regulatory agencies, potential disposals identified in regulatory approval orders and its past experience to assess whether an expected disposal should be reflected in the pro formas.

Pro formas for a significant business disposal (i.e., one that exceeds 20% significance) should be filed under Item 2.01 of Form 8-K when the disposal occurs.

Illustration 5-15: Disposal in connection with a 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 a material portion of its business 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 other transaction accounting adjustments to eliminate the assets, liabilities and operations that will be disposed of to obtain regulatory approval.

If the FCC had not approved the registrant's plan when the pro forma information was filed, the registrant would have additionally disclosed the uncertainty and the reasonably possible effects of resolving it in the explanatory notes to the pro forma financial information.

5.1.17 Management's adjustments

The following example illustrates disclosures that a registrant may provide as management's adjustments if management believes that such adjustments would enhance readers' understanding of the pro forma effects of a business combination and has a reasonable basis for each adjustment.

Illustration 5-16: Management's adjustments

On 10 August 20X9, Registrant A acquired XYZ Company and intends to achieve cost savings after the acquisition by leveraging its existing marketing infrastructure to sell the products of the combined company. Within one year after the acquisition, Registrant A plans to eliminate approximately 100 positions from XYZ's marketing organization.

Registrant A is filing pro formas along with Rule 3-05 financial statements for XYZ on Form 8-K and might make the following pro forma disclosures:

Notes to Unaudited Pro Forma Condensed Combined Financial Information

Note X. Management's adjustments

The tables below show the expected cost savings related to the Company's plans to leverage its existing marketing infrastructure to sell the products of the combined company after the acquisition. Within one year after the acquisition, the Company plans to eliminate approximately 100 positions from XYZ's marketing organization to achieve an annual pretax savings of approximately $10 million. The affected employees will receive termination benefits aggregating approximately $3 million. The terminations are presented below as if they had occurred on 1 January 20X8, and the statutory tax rate is 25%.

The adjustments shown below include those that management deemed necessary for a fair statement of the pro forma information presented. The adjustments include forward-looking information that is subject to the safe harbor protections of the Securities Exchange Act of 1934, and actual results could differ materially from what is presented below as efforts to integrate XYZ's operations into the Company's progress.

For the six months ended 30 June 20X9

	Net income	Basic and diluted earnings per share	Weighted average shares
Pro forma combined*	$ 28,207	$ 2.77	10,200
Management's adjustments			
Cost savings	5,000		
Tax effect	(1,250)		
Pro forma combined after management's adjustments	31,957	3.13	10,200

* As shown in pro forma income statement on page X-1.

For the year ended 31 December 20X8

	Net income	Basic and diluted earnings per share	Weighted average shares
Pro forma combined*	$ 57,824	$ 5.67	10,200
Management's adjustments			
Cost savings	10,000		
Severance	(3,000)		
Tax effect	(1,750)		
Pro forma combined net income after management's adjustments	63,074	6.18	10,200

* As shown in pro forma income statement on page X-2.

5.2 Acquisition of equity method investments

Acquiring an interest in a business accounted for under the equity method will trigger the requirement to provide Article 11 pro formas if the investment exceeds the significance threshold for a business 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 formas is not necessary. Instead, a company may include an adjustment to the pro forma income statement based on its pro rata share of the investee's 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 formas.

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 formas are not required in that situation (similar to the acquisition of financial assets). However, the SEC staff expects the registrant to explain 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.[15]

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

Illustration 5-17: Acquisition of an equity method investment

A calendar-year registrant acquires a 49% equity interest in Target 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	Transaction accounting 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
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.

5.3 Disposals

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

Illustration 5-18: Disposal

ABC Co., a calendar-year registrant, completed the sale of its digital business to XYZ Co. on 25 August 20X5 and is filing pro formas for this significant disposal 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 transaction accounting 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	Transaction accounting 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
Gain on disposal	-	20	(c)	20
Provision for income taxes	16	(4)	(d)	12

(EPS information not included in illustration)

Unaudited Pro Forma Condensed Combined Balance Sheet

As of 30 June 20X5

	Registrant historical	Transaction accounting adjustments	Notes	Pro forma
ASSETS				
Cash and equivalents	$ 1,350	$ 40	(e)	$ 1,390
Receivables	300	(50)	(f)	250
Inventories	2,220	(450)	(f)	1,770
Property, plant and equipment	7,700	(560)	(f)	7,140
	11,570	(1,020)		10,550
LIABILITIES				
Accounts Payable and accruals	3,010	(940)	(f)	2,070
Long-term debt	2,300	-		2,300
Deferred income taxes	1,257	(100)	(f)	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	(c)	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.

(c) This adjustment reflects the gain of $20 million arising from the transaction as of 25 August 20X5. 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.

(d) 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.

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

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

[Management's adjustments for any additional cost savings expected as a result of the disposal are excluded from this illustration]

5.4 Spin-off transactions

The following example illustrates disclosures about autonomous entity adjustments that may be provided by a newly spun-off registrant that was part of another entity.

Illustration 5-19: Autonomous entity adjustment

ParentCo, a calendar-year-end registrant, plans to spin off its subsidiary into a new public company (SpinCo) on 1 March 20X5. The historical financial information of SpinCo is taken from its carve-out financial statements that included $2 million of selling, general and administrative (SG&A) expenses allocated from ParentCo for providing certain administrative services to SpinCo. In connection with the spin-off transaction, SpinCo and ParentCo will enter into a transition service agreement (TSA), under which SpinCo will pay ParentCo a flat fee of $3 million per year to perform the administrative services for two years following the transaction.

SpinCo might provide the following pro forma disclosures in its Exchange Act registration statement filed on a Form 10 (in thousands):

Unaudited Pro Forma Condensed Combined Financial Information

For the year ended 31 December 20X4

	Registrant historical	Autonomous entity adjustments	Notes	Pro forma combined
SG&A expenses	2,000	1,000	(a)	3,000

Notes to Unaudited Pro Forma Condensed Combined Financial Information

(a) SpinCo's historical SG&A expenses for the year ended 31 December 20X4 included $2 million allocated from ParentCo for certain administrative services. In connection with the spin-off transaction, SpinCo will enter into a TSA and pay $3 million per year for two years post-transaction. The pro forma income statement is adjusted to reflect the expensing of the additional $1 million that will be paid annually to ParentCo for two years under the TSA.

5.5 Other transactions

5.5.1 Reorganization of entities under common control

Under ASC 805, when an entity transfers assets or liabilities to an entity with which it is under common control, 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 adjustments to capital accounts.

As discussed in section 4.2.2.1, 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 that would affect the computation of 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 5-20: 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	Transaction accounting adjustments	Notes	Other transaction accounting adjustments	Notes	Pro forma combined
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
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 illustration 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 arrangement is separate from the reorganization and shown as another transaction adjustment. 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.

5.5.2 Emergence from bankruptcy

Pro forma financial information in connection with a company's emergence from bankruptcy may be required under S-X Rule 11-01(a)(8) because it's material to investors. Transaction accounting 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. Examples of other transaction accounting 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.

Illustration 5-21: 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 (in millions). 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.

Unaudited Pro Forma Condensed Consolidated Balance Sheet

As of 31 December 20X4

	Registrant historical	Transaction accounting adjustments - claims settlements and financing		Transaction accounting adjustments - fresh start and other		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	Transaction accounting adjustments - claims settlements and financing		Transaction accounting adjustments - fresh start and other	Pro forma combined
Interest expense	—	55	(f)	—	55

[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 were 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 LSTC.

(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.

5.5.3 Use of proceeds in securities offerings

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 in the pro formas the receipt or application of offering proceeds reflecting one of the following amounts: (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 reflected in the pro forma financial information presented.

In capitalization tables, registrants also can (1) present both the minimum and the maximum amounts 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 5-22: Use of proceeds

In this example, the registrant does not have a specific corporate purpose for 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 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**

6 Other pro forma considerations

6.1 IPO considerations

As discussed earlier, Article 11 of Regulation S-X requires pro forma financial information for events or transactions that are material to investors. Historically, the SEC staff has required companies to present the additional pro forma disclosures described below in or alongside the historical financial statements in their IPO registration statements. However, amended Rule 11-02(a)(12) states that registrants cannot present pro forma financial information on the face of their historical financial statements or in the accompanying notes, except when such presentation is required by US GAAP or IFRS–IASB, as applicable.

As a result, we believe registrants should continue to determine whether additional pro forma information is material and evaluate the appropriate location for such disclosures.

6.1.1 Planned distributions not reflected in the historical balance sheet

Excerpt from SEC staff interpretations

Staff Accounting Bulletins

Topic 1.B.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.[16] If a planned distribution is not reflected in the latest balance sheet but would be significant relative to the reported equity, a pro forma balance sheet reflecting accrual of the subsequent distribution (but not giving effect to the offering proceeds) should be presented in the filing, regardless of whether the distribution has been declared or is to be paid from proceeds.

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

6.1.2 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 apply 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.

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 6-1: Pro forma EPS — dividends in excess of current-year earnings

Company A is planning an IPO 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 dividend exceeds current-year earnings by $2.5 million ($3.5 million dividend, less $1 million net income), 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. That is, because Company A would have to issue 400,000 shares to raise $2.5 million to pay the dividend ($2.5 million, divided by the offering price per share of $6.25), the pro forma EPS denominator would be calculated as follows:

Preexisting (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:

Preexisting (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).

6.1.3 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.[17] 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. However, losses should not be reclassified to the extent that paid-in capital becomes negative. 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 6.1.2 above.

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

6.1.4 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 after the latest balance sheet date 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) that gives effect to the change in capitalization.

If the conversion of outstanding securities or other changes in capitalization will occur after the latest balance sheet date and the conversion or change would materially affect EPS (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 should be included in the registration statement in addition to historical EPS.

6.1.5 Example — disclosure of pro forma financial information in an IPO

Illustration 6-2: Pro forma financial information in an IPO filing

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

- Before the IPO, Company A has 1 million shares of issued and outstanding common stock in addition to outstanding preferred stock that is convertible into 1 million shares of common stock 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.
- 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.

Company A might provide the following pro forma disclosure to reflect changes in capitalization in connection with the IPO.

Notes to Unaudited Pro Forma Condensed Combined Financial Information

Note 2 Pro forma Balance Sheet and Net Income Per Share

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

6.2 Financial forecasts

Excerpt from SEC Rules and Regulations

Regulation S-X, Article 11 Pro Forma Financial Information

Rule 11-03, Presentation of financial forecast

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

1. 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.

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

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

> 4. 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.
>
> (b) Such financial forecast shall be presented in accordance with the guidelines established by the American Institute of Certified Public Accountants.
>
> (c) Forecasted earnings per share data shall be substituted for pro forma per share data.
>
> (d) This section does not permit the filing of a financial forecast in lieu of pro forma information required by US GAAP or IFRS–IASB.

A financial forecast presents a company's expected results of operations, based on the conditions management expects to exist and the actions it expects to take. 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 and may be used to evaluate the outcome of different courses of action.

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*).

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

Illustration 6-3: 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 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 12 months ending 31 March 20X6.

6.2.1 Presentation and disclosure requirements

Forecasts must follow presentation guidelines issued in the American Institute of Certified Public Accountant'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. Assumptions must be supported by persuasive evidence (e.g., historical operating results, internal analyses, market surveys, 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.

6.3 Roll-up 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,[18] 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.

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[18] As part of its Disclosure Update and Simplification rule, which became effective 5 November 2018, the SEC amended various items in Regulation S-K to eliminate the requirement for registrants to present the ratio of earnings to fixed charges in SEC filings. However, the rule did not eliminate the disclosure requirement to present the ratio of earnings to fixed charges from Item 914 of Regulation S-K. We believe that this was unintentional, and the ratio of earnings to fixed charges would not be required under Item 914.

(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 and earnings-per-share amounts
- 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.

6.4 Tender offers

Excerpt from SEC Rules and Regulations

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

Item 1010, Financial statements

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

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

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

(3) 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 are offers to buy shares directly from security holders. Tenders may be made by either the issuer of the securities or by another 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 has to register them under the Securities Act of 1933, and the 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. Item 1010(b) of Regulation M-A requires pro forma information, if material, disclosing the following effects of the transaction:

- The effect on the company's most recent balance sheet
- The effect on the company's statement of income and EPS for the most recent fiscal year and the latest interim period
- The effect on 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 outcomes. See section 4.6.2 for further discussion when a tender offer may involve a range of possible outcomes.

6.5 Pro forma MD&A

When a registrant acquires a significant business 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 transaction accounting 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 on 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.[19]

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

6.6 Pro forma effects on non-GAAP financial 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 should not be presented on the face of any pro forma financial information required to be disclosed under Article 11 of Regulation S-X, and we believe pro forma adjustments to non-GAAP measures should exclude management's adjustments.

The following is an example of non-GAAP measures used in pro forma financial information:

Illustration 6-4: 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 the narrative disclosure required by Regulation S-K Item 10(e).]

A reconciliation of pro forma earnings before interest, taxes, depreciation and amortization (EBITDA) to pro forma Net Income (loss) determined in accordance with GAAP is provided below (in millions):

	Pro forma combined
Net Income (loss)	$ 227
Interest expense, net	240
Provision (benefit) for income taxes	142
Depreciation and amortization	424
EBITDA	1,033

6.7 Additional Form S-4 and proxy statement pro forma requirements (before the 19 November 2020 amendments to Regulation S-K are effective)

The SEC adopted amendments to Regulation S-K to eliminate certain disclosure requirements and to revise several others to make the disclosures provided in MD&A more useful for investors. The final rules (**Release 33-10890**), which we refer to as the 19 November 2020 amendments to Regulation S-K, are effective 10 February 2021.

Additional Form S-4 and proxy statement pro forma requirements apply to registrants that are applying the legacy rules. They should refer to section 7.4 of our ***December 2019 edition*** of this publication.

7 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 Public Company Accounting Oversight Board (PCAOB) Auditing Standard (AS) 2710, *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 AS 6101, *Letters for Underwriters and Certain Other Requesting Parties* (PCAOB AS 6101) (discussed in section 7.1 below), and PCAOB AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes* (PCAOB AS 4101).

PCAOB AS 4101 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 make sure that the auditor's name isn't used in a way that indicates his or her responsibility is greater than intended (e.g., the experts section doesn't imply that the financial statements were prepared by the auditor).

7.1 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 AS 6101 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.

7.2 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.

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SCORE no. 11609-211US

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