

The Committee of European Securities Regulators
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Your Ref: CESR/04-225b
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Dear Sir

Consultation Paper on CESR's recommendation for the consistent implementation of the European Commission's Regulation on Prospectuses no 809/2004

We welcome CESR's consultation document and wish to comment as set out below. Our responses are cross-referenced to the respective paragraph numbers containing the CESR's questions as follows;

Q37 Operating and financial review

We agree that it is appropriate to include key performance indicators about past performance. However, paragraph 35 suggests that the OFR should provide information about components of earnings and cashflow and "the extent to which they are recurring elements". In our experience, whilst it is possible to identify components of earnings and cashflow as unusual or "one-off" it is open to misinterpretation to refer to components of a company's results as "recurring" and this term is best applied to an entity's activities rather than earnings or cashflow.

Q 50/51 Profit forecast or estimates

Broadly we support the approach taken to profit forecasts and estimates and have the following comments. It is important that investors understand:

- i) the inherent uncertainty in any forecast;
- ii) what assurance they may derive by independent accountant or auditors reporting that the forecast is 'properly compiled'

The introduction of the principles in paragraph 44, particularly 'understandability' is helpful in dealing with uncertainty but more guidance is required to explain how the principles should be applied in practice.

It is important that there is an explanation of what is meant by 'properly compiled on the basis stated' and if the issuer were required to actually include an explicit description of the 'basis' on which the forecast has been prepared. One possible interpretation of 'properly compiled' might be that the principles of reliability, understandability and comparability had been applied in the preparation of the forecast. It is difficult to see how accountants or auditors could report on the application of relevance. However, another interpretation might be that it means that the forecast

accurately reflects the issuer's stated assumptions. Regardless of which approach is adopted the characteristics of reliability, understandability and comparability need greater explanation.

The principle of comparability in paragraph 44 is potentially in conflict with 13.3 because whilst 13.3 appears to relate to previously published financial information, we believe comparability should be judged principally by reference to future financial information ie, a forecast should be compared to the actual results which is what paragraph 44 appears to envisage.

Paragraph 45 describes the situation where a securities note is prepared subsequent to a prospectus that contained a profit forecast. If the issuer confirms that the forecast is still valid, as opposed to explaining why it is no longer valid, we would expect the independent accountant or auditor to confirm that their report is still valid as well. It is unclear exactly what paragraph 47 is requiring to be done - in particular when, and on what basis, a profit forecast on an acquired company is required to be included. A forecast by an acquired company is likely to have been prepared by the previous management/owners and on the basis of their accounting policies so it is difficult to see the relevance to the issuer.

Paragraph 48 requires that *any* non-recurrent items be disclosed. This is impractical – if the principle on understandability in paragraph 44 is applied then it should not be necessary to specify which additional information should be disclosed.

It would be helpful to provide further guidance as to what constitutes a profit forecast but this should be in the form of clear principles or attributes rather than specific examples.

Historical Financial Information

The second paragraph of item 20.1 requires that an issuer present its last two years historical information on the basis to be adopted in its next annual financial statements. Therefore an issuer with a 31 December year-end would not normally expect to adopt IFRS until it published its December 2005 financials statements with restated comparatives. If it issues a prospectus immediately after 1 July 2005, as the December 2005 accounts represent the "next" accounts, item 20.1 would require the issuer to restate its December 2003 numbers as well. We understand that the following provision is intended to prevent this occurring.

CHAPTER VI

Transitional and final provisions

Article 35

Historical financial information

1. The obligation for Community issuers to restate in a prospectus historical financial information according to Regulation (EC) No 1606/2002, set out in Annex I item 20.1, Annex IV item 13.1, Annex VII items 8.2, Annex X items 20.1 and Annex XI item 11.1 shall not apply to any period earlier than 1 January 2004 or, where an issuer has securities admitted to trading on a regulated market on 1 July 2005, until the issuer has published its first consolidated annual accounts with accordance with Regulation (EC) No 1606/2002.

However, the phrase 'any period earlier than 1 January 2004' is very unclear and it would be helpful if it were explained whether this refers to periods commencing or ending prior to that date.

CESR's recommendations do not deal with the issues that arise when the information contained in the issuer's annual financial statement for the last three years do not fairly portray the entity in which securities are being issued. Two examples of this are:

- i) changes in capital structure – this often occurs where the Issuer was company that was formed for the purpose of acquiring a trading company less than three years ago. Accordingly it will not have financial statements for three years whilst there will be a financial record of the underlying trading operations for that period.
- ii) a demerger transaction where a business which may not have historically prepared conventional annual financial statements is spun-off out of a larger group. For example because the business represents a division within a single corporate entity or a number of subsidiaries which in themselves do not form a legal group. In these circumstances some form of 'carve-out' accounting may be appropriate.

Guidance is required on how such information should be presented and, to the extent that it departs from GAAP, whether such non-GAAP accounting would be permitted.

In paragraph 78 it says that item 20.1 requires that *"The historical annual financial information must independently audited or reported on as to whether or not, for the purposes of the registration document, it gives a true and fair view, in accordance with auditing standards applicable in a Member State or an equivalent standard"*. Paragraph 81 appears to conclude that "audited or reported onfor the purposes of the registration document" means audited following the same professional requirements for a statutory audit. This seems to be unnecessarily limiting as, for example in the UK, it is possible to report in this way accordance with investment circular reporting standards which are not auditing standards.

Q92 Pro Forma Financial Information

Item 20.2 appears to require that, if pro forma information is included in a prospectus, it relates to both the net assets and earnings regardless of whether the 'significant gross change' relates to just net assets or earnings

The point made in paragraph 95 regarding contingent consideration is confusing; contingent consideration must by its nature be dependant upon a future event and we do not see how including contingent consideration in a pro forma could ever 'unduly' inflate net assets.

If a 'significant gross change' is to trigger the presentation of pro forma financial information then it follows that it should be defined by reference to financial information that will form the basis of the pro forma information. Therefore we would suggest that a 25% change in turnover or profit before tax could be viewed as a significant gross change for earnings statement purposes and change in tangible net assets of more than 25% for net asset purposes.

Q103 Financial data not extracted from the Issuer's Audited Financial Statements

As a matter of practicality we suggest that the proposal in paragraph 102 should be amended such that the other financial information is not given greater prominence than the audited historical financial information as on occasions this other information may be of more relevance than the audited historical financial information.

Q134 Working Capital Statements

The definition of working capital in paragraph 113, where it talks in terms of working capital being the "...ability to access cash and other liquid resources.....", is open to wide and varying

interpretations. We consider that working capital should be defined in terms of "... the access to cash and other liquid resources....." - the issuer should have the resources, not the just the ability to access them.

In paragraph 115 the equating of a high degree of confidence with reliability is unfortunate as in paragraph 44 reliability is given a different meaning. The investors should have confidence in the working statement if it has been prepared with the requisite amount of care.

Paragraph 116 addresses a difficult issue. Rather than the requirement being to consider "where information is available" we believe that the issuer should consider whether it has any reason to believe that working capital difficulties may arise beyond the 12 month period.

We disagree with paragraphs 121 and 122 which prohibit any additional disclosures with a "clean" working capital statement. There may be rare occasions when, whilst the issuer has taken care in selecting the assumptions underpinning the working capital statement there may be a matter outside of the issuer's control which could fundamentally impact on the working capital statement eg regulatory approval for a new drug or the outbreak of war in a key market. In these circumstances it would be helpful for investors to understand the uncertainty.

In paragraph 123 it is suggested that either a company has sufficient working capital or it does not. However, there will be circumstances where an issuer believes that they will have sufficient working capital but there is significant uncertainty, which may or may not attached to discrete events, such that it would be misleading to say that the company does not have sufficient working capital.

Q136 Capitalisation and indebtedness

In paragraph 135 it is not clear what is meant by the terms "indirect and contingent indebtedness" and guidance would be helpful.

Q155 Property Companies

In paragraph 148(6) it is not clear to us how a property valuation would be reconciled to the last annual accounts.

Q167 Mineral Companies

We have two comments in respect of paragraph 162.2(c). Firstly a cash flow estimate is not dependent upon the issuer's accounting standards and policies so we do not see how an independent accountant or auditor could give the opinion envisaged. Secondly we do not understand why this statement has been singled out for being reported on when, for example, a working capital statement is not. The inclusion of the word "properly" in the form of opinion will also give rise to considerable uncertainty as to what it means.

Start-up companies

Q188 In paragraph 179 it would be helpful to clarify that a company formed for the purpose of an acquisition (such as tends to be the case in a buy-out or demerger transaction) is not considered to be a start-up company. We believe that only those issuers that have not carried on a revenue earning trade, either by itself or through subsidiaries which form the majority of the issuer's group, should be treated as start-up companies.

Q187 The requirements of paragraph 185 would suggest that on all occasions the prospectus will contain a profit forecast, and given the requirement for sensitivities, is actually likely to include several forecasts. Presumably it is intended that such forecasts must comply with the principles set

out in paragraph 44? We would question whether such forecasts are ever likely to satisfy the reliability principle. This is because any business plan and sensitivity analysis for a start-up business is almost certain to include an element of hypothetical strategies. Additionally, if the same form of opinion is required on such projections as on profit forecasts by established issuers it could imply that an investor is able to place the same degree of reliance on such forecasts, which would be inappropriate. We therefore believe that further thought should be given to distinguishing such projections from other profit forecasts.

We trust that our responses are self-explanatory but should you wish to discuss any of these matters please contact either Steve Hextall (+44 20 7951 4636) or myself (+44 20 7951 3976).

Yours faithfully

For and on behalf of Ernst & Young LLP



Steve Parkinson
Partner