



Accountants &
business advisers

PKF Response to CESR Consultation on Historical Financial Information in Prospectuses

September 2005

Contents

1	Introduction.....	1
	Paragraph 27	1
	Paragraph 32	2
	Question 35	2
	Question 40	2
	Question 45	3
	Question 51	3
	Question 52	4
	Question 57	4
	Question 61	4
	Question 63	5
	Question 64	5
	Question 68	5
	Question 70	5
	Question 77	6
	Question 78	6
	Question 81	6
	Question 83	6

1 Introduction

- 1.1 On 7 July 2005, CESR published for consultation its recommendations for a possible amendment to the Prospectus Regulations in relation to historical financial information where the issuer has a complex financial history. This is thought to be required to enable investors to make informed assessments of the financial condition and prospects of the issuer.
- 1.2 PKF is a top 10 accounting firm which, in addition to its operations in the UK, also has significant operations in most European countries. Nevertheless, the comments set out in this document are a response by the UK firm only in relation to this Consultation Paper as the UK firm principally has experience of the UK markets and the manner in which the UKLA and, in the case of AIM PD prospectuses, the Nominated Advisers, will require information to be presented in Listing Documents.
- 1.3 In addition to being a major accounting firm, PKF has been very closely involved with the development of AIM since its formation in 1995 and, as a basic principle, wishes to enable it to retain its lighter regulatory touch whilst at the same time ensuring the highest practical levels of accuracy and professionalism in the presentation of information to prospective investors.
- 1.4 Our comments set out below generally reflect this over-riding mission statement.

Paragraph 27

- 1.5 Broadly we agree with the approach requiring additional disclosure where there is complex financial history. Without it, the likelihood is that the information provided would be misleading.
- 1.6 Whilst in most cases, common sense applied by the competent authority should be sufficient to enable a reader to make sense of the financial data, the needs for clarification, especially on some detailed points, is apparent. In particular, under Annex II, linking back to paragraph 20.1 of Annex I, the historic trading results need to cover, in our view, a 12 month period commensurate with the accounting reference date of the company whose securities are being offered.
- 1.7 There is some confusion as to what information should be provided by way of a balance sheet, ie. the implication is that the balance sheet should be drawn up as at the beginning of that accounting reference period. In our view, this is potentially more misleading than incorporating a balance sheet as at the end of the proposed accounting reference period, as has historically been the case with the “pro-forma net assets statement” previously employed in the UK.

Paragraph 32

- 1.8 PKF considers that the requirements for issuers having a complex financial history to make that information available should apply to a public offer or admission to trading on a regulated market of any equity security to which the share registration document applies. PKF sees little point in restricting the scope of this requirement as suggested. In addition, PKF also believes it should apply to AIM – PD Prospectuses as allowed for in the AIM Rules in the UK.
- 1.9 It is difficult to envisage a situation where this information would not be of assistance to a potential investor in making an investment decision.

Question 35

- 1.10 In a lot of cases, the smaller the issuing company, the greater is the significance of any changes which have occurred during the historic reporting period. It seems to PKF therefore that there should be no exemption or easing of the requirements in relation to small and medium sized companies. PKF does not believe that the additional cost of producing this information is overly burdensome and is concerned that, in its absence, investors may become suspicious and accordingly, decline to invest.

Question 40

- 1.11 The cases described should not be considered a comprehensive list. Other potential situations include :-
- 1.11.1 A company either buying or selling assets and liabilities rather than companies. Even though this will mean using management accounting information, we believe it is important to show the historic trading performance purely of those parts of the company which still constitute its operations at the Listing date. Hence, partial disposals or acquisitions of new streams of income by the acquisition of assets and the taking on of liabilities should be carefully apportioned to reflect the continuing activities.

- 1.11.2 An issue arises where a company would normally have to consolidate results of its investee companies if it “controlled” the company as set out in accounting standards. Nevertheless, this can lead to inconsistencies. For example, in one year the investee company was not controlled by the vehicle to be listed but, in the next year, became controlled for a period. then the company being listed was diluted back again into a minority position, thereby losing that control. In practice, in order to provide a consistent historical performance, the period under which it had control would be eliminated. This is but one example of the problems associated with associated companies and the varying degrees of control exercised over those associated companies during different periods within the historical reporting information period.
- 1.11.3 Another anomaly which will occur over the next year or two is where companies transfer to IFRS. If the entities being reported on change to IFRS at different times, again these accounts should be restated to reflect the position of the company whose securities are to be listed. This can present some practical difficulties and hence a degree of flexibility over the accuracy of this approach might need to be considered.

Question 45

- 1.12 PKF agrees with the proposed approach. In the case of a new holding company, in PKF’s view, all acquisitions by way of a share for share exchange to effect the insertion of a newly incorporated holding company over an established business is likely to meet the “significant” test. However, as mentioned above in relation to associated company investments, care will be needed as it will be easy for any of these investments to trigger the 25% test and yet fall short of the control element required.

Question 51

- 1.13 Of the three options, we strongly support option 3, namely the alignment of accounting standards in line with those of the issuer. The problem with the other two options, together with their reconciliations, is that the level of disclosure and detail required would be considerable and we believe that it would be far more likely that potential investors would either get confused or be baffled by the complexity and ignore it entirely. In view of some of the significant variations in accounting standards, this could lead to a very misleading picture of the historic financial information being presented.

Question 52

- 1.14 As we mentioned earlier, this favouring of option 3 can cause practical difficulties, and whilst in all cases the information should be requested, the competent authorities should be willing to listen to arguments concerning the impracticality or the huge cost burden that might be involved and to then take a pragmatic view. If such a pragmatic view is taken, then the matter needs to be clearly stated in the Admission Document, along with the reasons given by the issuer for adopting a different approach. However, the intention should be that the number of exceptions to the rule are minimal. So far as the method of conforming, we are strongly in favour of a re-statement rather than a reconciliation or narrative description for reasons stated above.
- 1.15 So far as the costs are concerned, it is impossible to make a general rule. Firstly, it depends upon the different accounting standards involved – some countries' GAAP are very much more in line with IFRS than others. Equally, since IFRS is not compulsory yet for AIM companies, additional problems may arise if, for example, the AIM company is not drawing up accounts under IFRS but any newly acquired subsidiary (perhaps having been part of a larger fully listed company previously) does comply. We believe the competent authority should be given sufficient discretion to apply a pragmatic approach. After all, it is in the issuing company's interests to ensure that the information provided is such that it attracts investors for its proposed issue of securities and hence, in practice these matters should not be the cause of considerable friction.

Question 57

- 1.16 We believe either option 2 or option 3 should be followed. The difference between the two options seems to be minimal. Option 1 we believe would be dangerous. The cashflow statement and the statement of changes in equity would relate to a highly theoretical position. This is because the company whose information is being disclosed was not part of the issuer at the relevant time. Cashflow statements and changes in equity are therefore irrelevant and quite possibly misleading.

Question 61

- 1.17 PKF agrees with this approach in principle. However, especially in relation to AIM companies, in a lot of cases, as the audit threshold has been raised significantly in recent years, the acquiring businesses have not been the subject of a statutory audit. In our view, it would not be cost effective to ask that those companies be "retro-audited". Nevertheless, we believe a statement should be included in the Admission Document, making it clear that the company involved fell below the audit threshold and accordingly, the Reporting Accountant is unlikely to be in a position to provide a true and fair view and opinion thereon.

- 1.18 We agree that if any audit reports on the historic financial information contain qualifications, disclaimers or an abject refusal to give an opinion, then this fact should be clearly stated in the Admission Document, along with a full explanation. Such a course of action would, in our experience of the UK market, normally mean that the Admission could not proceed. Hence, an alternative solution might need to be provided, eg. the assets and liabilities of the company whose audit was qualified, being acquired rather than the company itself, thereby leaving behind any undisclosed liabilities.

Question 63

- 1.19 We agree that there should be auditor's involvement concerning the reconciliation or narrative description of differences in accounting standards. The "check and balance" required to enable an auditor to express an opinion will, in our view, prevent the conversion of one standard to another being used as a means of manipulating the financial results unfairly.

Question 64

- 1.20 PKF does not believe that full scope audit would be practical in a lot of circumstances and hence, we cannot recommend Option a). Insofar as Option b) or c) is concerned, we believe it should be left to the discretion of the competent authority. Clearly, there is a degree of materiality involved. If the materiality level is low, then Option c) is sufficient. If, however, the materiality level is high, then a full review scope would need to be undertaken.

Question 68

- 1.21 We agree with this approach since this is the only way in which investors can get a reasonable understanding of the business in which they are investing. However, the Reporting Accountant will be in some difficulty in expressing an opinion upon that information as it itself has not been subject to audit. Accordingly, it is likely that the Reporting Accountant can merely confirm that the information has been properly compiled in line with the basis stated. Whether this provides sufficient investor protection will again depend upon materiality involved.
- 1.22 The subject of costs is difficult to comment on since, in this case, the amount of work required is entirely dependent upon the complexity and accuracy of the internal or management accounts of the issuer. Again, the relevance and usefulness of a cashflow statement needs to be considered separately in our view.

Question 70

- 1.23 Our reply is the same as for Question 64.

Question 77

- 1.24 We are not keen on Option a) as we believe this will leave the potential investor in the dark as to the financial effects of the transaction involved. Accordingly, we recommend Option b) be required.

Question 78

- 1.25 PKF does not intend to propose any other option to deal with these situations.

Question 81

- 1.26 PKF agrees with this approach. Again, it is difficult to see how a prospective investor can properly judge the information if these proposals are not followed.

Question 83

- 1.27 We believe this matter is over-simplified. Where one particular entity has changed its accounting date, then we agree that the historic financial information should be presented for at least three calendar years. The more complex issue arises when differing organisations merge which have different accounting reference dates. The complexity in time apportioning these historical trading results, and their inherent inaccuracy, needs to be considered. If the resultant historical information could be construed as misleading, PKF believes that individual accounting periods should be separately reported on for each entity and no attempt should be made at consolidating this information. This is less than ideal but is probably preferable to issuing documents which might later turn out to be misleading.

End.