**FASB Emerging Issues Task Force**

**Issue No.** 10-G

**Title:** Disclosure of Supplementary Pro Forma Information for Business Combinations

**Document:** Issue Summary 1*

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**Date previously discussed:** None

**Previously distributed EITF materials:** None

## Background

1. Topic 805, *Business Combinations*, requires public entities to disclose pro forma information for business combinations that occurred during the reporting period. Specifically, paragraph 805-10-50-2(h) requires public entities to disclose the following information (in part):

> The revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period (supplemental pro forma information)
>
> If comparative financial statements are presented, the revenue and earnings of the combined entity for the comparable prior reporting period as though the acquisition date for all business combinations that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (supplemental pro forma information).

2. Those disclosure requirements are also applicable for interim reporting periods, and are required to be presented in the financial statements for as long as the period of acquisition is

* **The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

included in the financial statements. The disclosures under Topic 805 are required to be presented on an aggregate basis for individually immaterial business combinations occurring during a reporting period that are material collectively. This supplemental pro forma information is included in an unaudited note to the financial statements. If this disclosure is deemed to be impracticable, the entity must disclose that fact and explain why the disclosure is impracticable.

3. Similar pro forma disclosure requirements were required under both APB Opinion No. 16, *Business Combinations*, and FASB Statement No. 141, *Business Combinations*. The Board gave consideration to the pro forma information disclosure requirements during deliberations for both Statements 141 and FASB Statement No. 141(R), *Business Combinations*, during which time certain respondents indicated that the inclusion of pro forma information is useful for measuring organic growth and in assessing the progress towards synergies expected to result from the business combination.

4. The SEC also requires its registrants to prepare pro forma financial information to be included in a Form 8-K for business combinations that are determined to meet a significance threshold as defined under Rules 1-02(w) and 305 of Regulation S-X. The purpose of this pro forma financial information is to provide investors with information about the continuing impact of a particular transaction by showing how it might have affected the historical financial statements if the transaction had been consummated at an earlier time. The pro forma financial information should assist investors in analyzing the future prospects of the registrant because it illustrates the possible scope of the change in the registrant's historical financial position and results of operations caused by the transaction. That pro forma financial information is to be prepared under Article 11 of Regulation S-X, which requires that pro forma results of operations be presented for the most recent annual fiscal year and the subsequent interim period, if applicable. Article 11 permits, but does not require, the inclusion of pro forma information for the comparative interim period, but not for the comparative annual period. Article 11 pro forma financial information is not included in the financial statements and requires a more extensive presentation than the financial statement disclosure requirements under Topic 805.

5. Appendix 10-GA includes a comparison of certain of the pro forma disclosure requirements under Topic 805 and Article 11.

6. The staff is aware that diversity exists in practice as to whether the pro forma financial information required to be disclosed under Topic 805 should be prepared as if the business combination occurred at the beginning of each of the current and prior annual periods, or only at the beginning of the prior annual period. Certain constituents have indicated that they believe that the pro forma results should be prepared as if the business combination occurred at the beginning of the prior annual period for purposes of calculating both the prior reporting period and the current reporting period pro forma financial information. Those constituents believe that presenting pro forma results as if the business combination occurred at the beginning of each annual period inappropriately results in certain adjustments that impact pro forma earnings being included in the pro forma results of both reporting periods. That result primarily arises when pro forma adjustments include amortization expense of intangible assets with useful lives of less than two years and expense related to the fair value step-up of acquired inventory with a turnover of less than two years.

**International Convergence**

7. IFRS 3, *Business Combinations*, permits, but does not require pro forma disclosures for the comparative period. The IASB indicated that the preparation of prior period pro forma information could be impracticable due to the potential difficulty and cost to obtain the required prior year financial information in certain international jurisdictions.

**Scope**

8. This Issue applies to all public entities, as defined in Topic 805, that have entered into a material business combination, or a series of immaterial business combinations that are material in the aggregate.

**Accounting Issues and Alternatives**

**Issue 1: When comparative financial statements are presented, whether supplemental pro forma disclosures should be prepared assuming that the business combination occurred (a)**

**at both the beginning of the current annual period for the current reporting period and the beginning of the prior annual period for the prior reporting period, or (b) at the beginning of the prior annual period for both reporting periods.**

*View A: The pro forma disclosure should be presented as if the business combination occurred at the beginning of the current annual period for the current reporting period and at the beginning of the prior annual period for the prior reporting period.*

9. Proponents of View A emphasize the value of consistency in analyzing the effect of a business combination. They believe that the importance of disclosing trends is greater than the importance of illustrating the actual economics underlying the transaction for purposes of this pro forma disclosure. Including the effect of the transaction as though it occurred at the beginning of the current annual period in order to calculate the current reporting period pro forma information, and at the beginning of the prior annual period to calculate the prior reporting period pro forma information, provides more relevant information for historical analysis, and allows users to gain a better understanding of the effect of the business combination.

10. Proponents of View A believe that if the adjustments arising from the acquisition are reflected as though the business combination occurred only at the beginning of the prior annual period for both reporting periods, it would reduce comparability. For example, assume that an entity completes a business combination in July 2010, and the acquisition results in the recognition of a material intangible asset to be amortized over a one year useful life. Proponents of View A believe that the amortization expense associated with the intangible asset should be included in both the 2009 and 2010 pro forma financial information. If the current reporting period pro forma financial information excludes the amortization expense, while the prior reporting period includes the amortization expense, there would be an increase in pro forma earnings from the prior period to the current period resulting from the pro forma adjustment.

11. Proponents of View A believe that Topic 805 is clear in that entities must disclose pro forma results of operations as if the acquisition date was the beginning of the prior annual period for purposes of calculating the prior reporting period pro forma results, and the beginning of the

current annual period for purposes of calculating the current reporting period pro forma results, if presenting comparative financial statements.

12. Opponents of View A believe that the purpose of the comparative period pro forma disclosure is to illustrate the true underlying economic reality of the combined entities, rather than to disclose comparative trends for the reporting periods.

*View B: The pro forma disclosure should be presented as if the business combination occurred at the beginning of the prior annual period for purposes of calculating* <u>*both*</u> *the current reporting period and the prior reporting period pro forma financial information.*

13. Proponents of View B believe that the pro forma adjustments should be calculated assuming that the business combination was completed as of the beginning of the prior annual period for the prior reporting period and, if applicable, carried forward through the current reporting period. For example, if an intangible asset acquired in a business combination is being amortized over an estimated useful life of 18 months, the prior year pro forma results would reflect 12 months of amortization expense, while the current year pro forma results would reflect the remaining 6 months of amortization expense. Proponents of View B believe that it is inappropriate to include the same effect of the acquisition adjustments in both the prior and the current reporting period pro forma disclosures. Proponents of View B believe that reporting the acquisition on a pro forma basis as if it only occurred in the prior reporting period represents the true underlying economic reality of the combined entities. Accordingly, proponents of View B emphasize the importance of economic reality over the need to disclose comparative trends.

14. Proponents of View B also note that under current guidance, if in addition to the current period acquisition, an acquisition was also completed in the prior reporting period, the comparative pro forma results are not required to include results of the prior reporting period acquisition as though that prior period acquisition occurred at the beginning of the prior annual period. The prior reporting period pro forma results are only adjusted for acquisitions that

occurred in the current reporting period. Accordingly, those supporting View B believe that for situations in which acquisitions occurred in the current and prior reporting periods, the pro forma results do not provide comparable information to identify trends.

15. Opponents of View B believe that View B results in pro forma financial information that is not comparable. Opponents of View B also believe that Topic 805 does not indicate that the current reporting period pro forma financial information is to be presented as if the business combination was completed as of the beginning of the prior annual period and then carried forward through the current reporting period. Opponents of View B note that this presentation can result in actual charges related to the current year acquisition being excluded from the pro forma earnings of the current period, which they believe is an inappropriate presentation.

16. Based on the user outreach performed by the staff, none of the analysts indicated a strong preference regarding View A or View B; however, most believe that View B is the more appropriate presentation. Each of the analysts provided suggested enhancements that would make the pro forma disclosures under both View A and View B more useful as discussed further below.

**Issue 2: Whether the Task Force wishes to consider additional enhancements to the existing pro forma disclosure requirements under Topic 805, as suggested by users.**

17. The disclosure requirements for pro forma financial information related to business combinations vary significantly when comparing the FASB's requirements under Topic 805 and the SEC's requirements under Article 11 of Regulation S-X. During the user outreach performed by the FASB staff in connection with Issue 1, all users noted that the pro forma financial information disclosure requirements under Topic 805 should be expanded and conformed in some, or all respects, to the SEC's requirements under Article 11.

18. Users noted that the requirement under paragraph 805-10-50-2(h) to disclose actual revenue and earnings of the acquiree from the acquisition date through the date of the reporting period provided useful information for determining organic growth of the post-combination entity.

However, those disclosure requirements are made only when practicable, and therefore may not be included in all financial statements. Users indicated that the pro forma financial information also disclosed under paragraph 805-10-50-2(h) would be more useful if accompanied by a narrative description of the nature and amount of material, nonrecurring pro forma adjustments, as had been previously required under Statement 141.

**Question 1 – Does the Task Force believe that the pro forma disclosures under Topic 805 should be accompanied by a narrative description of the nature and amount of material, nonrecurring pro forma adjustments?**

19. Users also noted that the disclosure of pro forma (a) pre-tax earnings, (b) gross or operating margin, and (c) cash flows from operations would improve the usefulness of the pro forma financial information. While the staff believes that disclosure of pro forma cash flows from operations would provide useful information, it is likely to be an impracticable disclosure requirement because the information may not be available, and is not required under Article 11. Users indicated that they prefer the nature of presentation (multi-columnar format showing the historical results of each entity, pro forma adjustments, and pro forma results as adjusted) and the accompanying note disclosures required under Article 11.

20. The staff notes that the observations and suggestions for improvement provided by the users are similar to the feedback received during the outreach performed in connection with the issuance of both Statements 141 and No. 141(R).

**Question 2 – Does the Task Force want to pursue the need to make further improvements, as noted above, to existing pro forma disclosure requirements under Topic 805?**

**Transition Method**

21. If the Task Force reaches a consensus on either View A or View B for Issue 1, the Task Force will need to determine the appropriate transition method for public entities that would be required to change the manner in which they present supplemental pro forma financial information.

*View A: The consensus should be applied on a prospective basis as of the date of adoption.*

22. Proponents of View A believe that this guidance should be applied on a prospective basis. Proponents of View A acknowledge that in instances in which an entity completed a material business combination in each reporting period, the basis of pro forma presentation for acquisitions completed in the current and prior reporting periods would differ. However, they do not believe that users of the financial statements would require comparability between the distinct pro forma financial information disclosed for business combinations completed in the current reporting period and those completed in the prior reporting period.

23. If the Task Force determines that View A is the appropriate method of transition, the staff believes that the guidance should be applied prospectively to business combinations completed on or after the beginning of an annual reporting period. Requiring an effective date that aligns with the beginning of a new annual reporting period would be consistent with the transition requirement of Statement 141(R) and would eliminate potential inconsistencies in an entity's pro forma financial information in situations in which an entity completed business combinations throughout the reporting period.

24. Opponents of View A believe that prospective application can result in the pro forma financial information being calculated and presented under different methods for prior and current period acquisitions, resulting in an inconsistent application of the same disclosure requirement.

*View B: The consensus should be applied on a retrospective basis to all prior periods as of the date of adoption.*

25. Proponents of View B believe that in order to achieve consistency in reporting the pro forma financial information between business combinations completed in the current and prior reporting periods, this guidance should be applied on a retrospective basis. The staff believes that

the information required in order to apply this guidance on a retrospective basis for all prior period business combinations presented in the financial statements generally will be available.

26. Opponents of View B believe that as described under View A, users would not require comparability between the distinct pro forma financial disclosures for business combinations completed in the prior and the current reporting period.

**Appendix 10-GA**

## PRO FORMA DISCLOSURE REQUIREMENTS

The table below includes a comparison of certain of the pro forma disclosure requirements under Topic 805 and Article 11:

| | **Topic 805** | **Article 11** |
|---|---|---|
| **Materiality** | Disclosure is required for business combinations that are material on an individual and aggregate basis, as determined in the context of financial statement materiality. | Form 8-K is required to be filed when a business combination meets the significance test of Regulation S-X (20 percent threshold of assets, income, or investment). Business combinations individually below 20 percent, but greater than 50 percent in the aggregate trigger Form 8-K reporting requirements. |
| **Periods Presented** | Current period and comparative prior period for results of operations. No pro forma balance sheet is required. | Latest fiscal year and subsequent interim period (if applicable) for results of operations. Comparative interim period is permitted, but not required. A pro forma balance sheet is required as of the most recent balance sheet date. |
| **Timing** | To be disclosed in the notes of the first Form 10-Q or Form 10-K filing following completion of the business combination. | Pro forma financial information is to be filed in a Form 8-K within 75 days of the acquisition date. |
| **Disclosure Requirements** | Requires disclosure of pro forma revenue and earnings. No specific requirement exists for accompanying narrative disclosures. | Pro forma results of operations (continuing only) and balance sheet is prepared on a condensed basis, along with accompanying footnotes. All adjustments are to be referenced to notes that clearly explain the assumptions involved.<br><br>Basic and diluted earnings per share amounts and disclosure of the number of shares used to compute per share data are required. |

| | Topic 805 | Article 11 |
|---|---|---|
| **Pro forma Adjustments** | Does not provide guidance as to the determination of the pro forma revenue and earnings figures to be disclosed. Requires inclusion of both recurring and nonrecurring pro forma adjustments. | Pro forma adjustments are to be reflected if they are (a) directly attributable to the transaction, (b) factually supportable, and (c) expected to have a continuing impact on the entity. Material nonrecurring charges directly related to the acquisition that will be included in the income statement within the 12 months following the acquisition are reflected directly in retained earnings and disclosed.<br><br>Pro forma adjustments related to the income statement are to be computed assuming the transaction occurred at the beginning of the annual period presented. |