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A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions

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Preface

Parent companies often have questions about how to prepare "carve-out financial statements" (separate financial statements derived from the financial statements of a larger parent company). Certain SEC staff guidance addresses some elements of carve-out financial statements (e.g., when the statements will be included in an SEC filing), and parent companies often analogize to the SEC staff's guidance on preparing financial statements for nonpublic carve-out entities. However, there is no single set of comprehensive guidance on preparing financial statements for carve-out entities.

To help companies streamline the preparation of these financial statements, Deloitte's *A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions* summarizes key factors for them to consider. Such considerations are presented in the following sections and appendixes:

- "Overview" — Discusses the basic principles of a carve-out transaction and provides considerations for management to use in identifying the carve-out entity and navigating the carve-out process.
- "Management Considerations" — Highlights some practical considerations that management should take into account when preparing carve-out financial statements.
- Section 1, "Accounting Considerations Related to a Carve-Out Entity's Balance Sheet" — Provides accounting and disclosure guidance on common balance sheet items included in the carve-out financial statements.
- Section 2, "Accounting Considerations Related to a Carve-Out Entity's Statement of Comprehensive Income" — Provides accounting and disclosure guidance on common income statement items included in the carve-out financial statements.
- Section 3, "Other Accounting and Financial Reporting Items" — Expands on the items introduced in Sections 1 and 2 by providing additional accounting and financial reporting guidance on topics such as income taxes, discontinued operations, and subsequent events.
- Section 4, "SEC Reporting Topics" — Discusses the various SEC accounting and financial reporting topics that carve-out entities and the parent company need to consider when preparing IPO filings and post-carve-out-transaction SEC filings.
- Appendix A — Glossary containing the full titles of topics, standards, and regulations used in the Roadmap.
- Appendix B — Glossary containing the full forms of acronyms used throughout the Roadmap.
- Appendix C — Glossary containing definitions of terms used throughout the Roadmap.

We hope that you find this publication a valuable resource as you prepare your carve-out financial statements, and we are grateful to the publication's contributors. Among them are Lyndsey McAlister, Ken Pressler, Sean Prince, Elsye Putri, Stefanie Tamulis, Andy Winters, and Amy Zimmerman as well as Geri Driscoll, Joseph Renouf, and Lora Spickler-Alot in our Production group. Joe DiLeo and Stuart Moss supervised the overall preparation of this Roadmap and extend their deepest appreciation to all professionals who helped in its development.

We welcome your feedback on this Roadmap. Please send us your thoughts and suggestions.

Overview

A carve-out occurs when a parent company segregates a portion of its operations and prepares a distinct set of financial information in preparation for a sale, spin-off, or divestiture of the "carve-out entity." The carve-out entity may consist of all or part of an individual subsidiary, multiple subsidiaries, or even an individual segment or multiple segments. In some cases, one or more portions of a previously consolidated parent company's subsidiaries may create the newly defined carve-out operations.

"Carve-out financial statements" is a generic term used to describe separate financial statements that are derived from the financial statements of a larger parent company. The form of those financial statements may vary, however, depending on the situation. For example, if the acquisition is small, a strategic buyer of a carve-out entity may be satisfied with an unaudited balance sheet and income statement for the most recent fiscal year. Another public buyer, however, may require a full set of SEC-compliant audited financial statements, including footnotes, for the three most recent fiscal years, while yet a third buyer might ask that the periods be audited but be completely unconcerned with SEC reporting considerations. Accordingly, assessing the potential audience is critical to understanding the basis of presentation and the number of periods needed. Such an assessment can be particularly tricky when the carve-out financial statements are being prepared before the buyer or potential buyers are identified.

Identifying the Carve-Out Entity

Once the purpose of the carve-out transaction has been identified, management should turn its attention to defining the operations to be included in the carve-out. This is the most important step in the carve-out process. If management were to incorrectly identify the operations to be included in the carve-out, the carve-out financial statements would be misstated regardless of whether the appropriate periods were presented and revenues/expenses and assets/liabilities were reasonably allocated.

Identifying the carve-out operations can be complex because there is currently no detailed accounting guidance on preparing carve-out financial statements. In a best-case scenario, the terms and conditions of the purchase-and-sale agreement will outline the assets and liabilities and legal entities that the carve-out entity comprises. However, it is more difficult to prepare carve-out financial statements for a spin-off or divestiture in advance of a formal agreement.

Carve-out financial statements should present information about all aspects of the carve-out entity's historical results and operations (i.e., provide balanced and transparent financial information that reflects all of the operation's historical successes and failures). Foresight and future business decisions should not be incorporated into the carve-out financial statements. In instances in which the carve-out financial statements may include assets or operations that will not be part of the ultimate carve-out transaction, an entity would typically provide pro forma financial information to adjust the historical carve-out financial statements to reflect only the net assets and operations being carved out. See the pro forma discussion in the Pro Forma Financial Information (Article 11) section for more information.

Historical Results and Operations

A segment or reporting unit[1] with defined financial results may be a good starting point for identification of the carve-out entity; often, however, only a portion of a segment or reporting unit is being divested, increasing the difficulty of identifying the assets and liabilities related to the carve-out entity. Management must consider where certain employees and assets will reside after the carve-out transaction. Understanding whether these individuals and assets represent a portion or all of certain operating, reporting, or legal structures may help illuminate the appropriate basis of presentation.

[1] ASC 350-20-20 defines a reporting unit as "an operating segment or one level below an operating segment (also known as a component)."

Management must also evaluate whether an entire entity or multiple entities are being divested or whether only portions of one or more entities are being carved out. In preparing the historical financial statements, management must consider any prior restructuring activities. In other words, management needs to evaluate any historical acquisitions or divestitures to determine whether to include them in the historical periods. In a speech at the 2001 AICPA National Conference on Current SEC Developments, SEC staff member Leslie Overton indicated that if the carve-out entity, for example, is a registrant or will undergo an IPO,[2] the carve-out financial statements "should include all relevant activities that have been a part of the history of the business and that can be expected to repeat as the business continues in the future."

Legal Structure

Because it directly affects the nature of the carve-out financial statements and can be used as a basis for evaluation of the historical financial results, the legal structure of the carve-out is critical. However, in some instances, the legal structure is often established for tax purposes and may include portions of or complete product lines or geographies that may not align with the carve-out entity. A carve-out may be a single legal entity (or a portion of a single entity), a group of legal entities, various business lines with no legal entity status, or a combination of these. Management must consider both the accounting and income tax implications of including certain legal entities in (or excluding them from) the carve-out entity. In many cases, detailed financial information may not be readily available on an entity-by-entity level.

[2] For the full forms of acronyms, see Appendix B.

Management Considerations

Preparation of the carve-out financial statements can be challenging and often requires management to use judgment and carefully plan ahead. Below are some considerations that management should take into account when preparing carve-out financial statements.

Assembling the Right Team

Involving the appropriate personnel is an integral step in planning for carve-out transactions. Management should evaluate which employees could help provide the information it needs to prepare accurate and complete financial statements. Such employees may include those outside accounting (e.g., in operations or human resources). In addition, management may need to engage external specialists (e.g., tax or valuation specialists) to help it develop estimates and allocate certain account balances to the carve-out financial statements.

Materiality

For financial reporting purposes, management should compare the carve-out entity's size with that of the consolidated parent company. If the carve-out entity is small in relation to the parent company, amounts that were not considered material to the consolidated group may be material to the carve-out entity's operations. Because the materiality thresholds related to the carve-out financial statements would most likely be lower, management may need to examine accounts and balances more carefully than it has in the past. In such cases, management may therefore identify required adjustments that were previously considered immaterial to the parent's historical consolidated financial statements.

Internal Controls

Management should establish processes and controls for creating carve-out financial statements (e.g., management may need to establish controls related to allocation development). Although an entity may often be able to leverage existing financial statement preparation controls, management should evaluate whether it needs to modify such controls to accommodate process changes related to the carve-out financial statements.

Supporting Documentation

Management should consider the type of documentation necessary to support the assumptions made and results achieved in developing carve-out financial statements. In some cases, the supporting documentation may already exist (e.g., compensation expense is usually calculated and allocated on an employee-by-employee basis). However, management may need to develop and maintain new documentation for the allocations made for the carve-out financial statements (e.g., a rational and systematic method for allocating SG&A expenses).

A best practice is for management to use existing accounting systems as much as possible when preparing carve-out financial statements. The use of existing accounting systems may be limited, however, depending on the level of detail at which the account balances are maintained as well as the structure of the carve-out entity (e.g., whether the carve-out represents a segment of the parent or only part of a segment). If the carve-out entity represents a historical segment or component for which the parent had tracked its account balances separately, management may be able to easily extract information from its existing accounting records. However, if the carve-out entity includes portions of different historical segments, further involvement of IT specialists may be required.

Working With Auditors

If, as part of the preparation of carve-out financial statements, external auditors need to issue an audit opinion, management should assist its auditors by developing a process for collecting and maintaining all supporting documentation used in the preparation of the carve-out financial statements. For balances in which judgment or complex estimates are required, management should ensure that its documentation contains enough detail for auditors to reach conclusions about the reasonableness of the amounts allocated to, and balances presented in, the carve-out financial statements. Compiling proper documentation may be instrumental in avoiding unwanted surprises during the audit.

Section 1 — Accounting Considerations Related to a Carve-Out Entity's Balance Sheet

Before preparing the carve-out financial statements, management must determine the purpose of such financial statements and what portion of the operations should be included in them. Entities will often begin by going through the financial statements line by line (e.g., cash; accounts receivable; property, plant, and equipment). For financial statement items that are inherently related, such as accounts receivable and revenue, entities can often determine the allocation simultaneously for such related line items in the carve-out financial statements. For many of the balances, this process may be quick, but for others it can be time-consuming. Entities can streamline this process by identifying the most challenging issues from the outset. This section addresses the more complex balance sheet items; for some of these line items, specialized accounting guidance exists (e.g., pensions, share-based payments, income taxes).

Pushdown of Debt and Related Items

Question 3 of SAB Topic 5.J (codified in ASC 805-50-S99-1) discusses pushdown of acquisition-related debt. Question 3 states:

> **Question 3:** Company A borrows funds to acquire substantially all of the common stock of Company B. Company B subsequently files a registration statement in connection with a public offering of its stock or debt. Should Company B's new basis ("push down") financial statements include Company A's debt related to its purchase of Company B?
>
> **Interpretive Response:** The staff believes that Company A's debt, related interest expense, and allocable debt issue costs should be reflected in Company B's financial statements included in the public offering (or an initial registration under the Exchange Act) if: (1) Company B is to assume the debt of Company A, either presently or in a planned transaction in the future; (2) the proceeds of a debt or equity offering of Company B will be used to retire all or a part of Company A's debt; or (3) Company B guarantees or pledges its assets as collateral for Company A's debt. Other relationships may exist between Company A and Company B, such as the pledge of Company B's stock as collateral for Company A's debt. While in this latter situation, it may be clear that Company B's cash flows will service all or part of Company A's debt, the staff does not insist that the debt be reflected in Company B's financial statements providing there is full and prominent disclosure of the relationship between Companies A and B and the actual or potential cash flow commitment. In this regard, the staff believes that FASB ASC Topic 450, Contingencies, FASB ASC Topic 850, Related Party Disclosures, and FASB ASC Topic 460, Guarantees, require sufficient disclosure to allow users of Company B's financial statements to fully understand the impact of the relationship on Company B's present and future cash flows. Rule 4-08(e) of Regulation S-X also requires disclosure of restrictions which limit the payment of dividends.
>
> Therefore, the staff believes that the equity section of Company B's balance sheet and any pro forma financial information and capitalization tables should clearly disclose that this arrangement exists. Regardless of whether the debt is reflected in Company B's financial statements, the notes to Company B's financial statements should generally disclose, at a minimum: (1) the relationship between Company A and Company B; (2) a description of any arrangements that result in Company B's guarantee, pledge of assets or stock, etc. that provides security for Company A's debt; (3) the extent (in the aggregate and for each of the five years subsequent to the date of the latest balance sheet presented) to which Company A is dependent on Company B's cash flows to service its debt and the method by which this will occur; and (4) the impact of such cash flows on Company B's ability to pay dividends or other amounts to holders of its securities. Additionally, the staff believes Company B's Management's Discussion and Analysis of Financial Condition and Results of Operations should discuss any material impact of its servicing of Company A's debt on its own liquidity pursuant to Item 303(a)(1) of Regulation S-K. [Footnotes omitted]

Many companies are faced with the question of whether parent-company debt, which has historically not been "pushed down" to the financial records of a subsidiary, should be reflected in a carve-out entity's financial statements. The answer depends on whether the parent's debt includes the carve-out entity's transaction-related debt. To help companies consider whether the parent's debt is within the scope of the guidance, SAB Topic 5.J outlines the following example:

1. Company A borrows funds to acquire substantially all of Company B's common stock.
2. Company B subsequently files a registration statement in connection with a public offering of its stock or debt.
3. Company B guarantees or pledges its assets as collateral for Company A's debt.

SAB Topic 5.J indicates that in such cases, Company A's debt, related interest expense, and allocable debt issue costs should be reflected in Company B's separate carve-out financial statements if the carve-out entity meets any of the following criteria:

- Company B is to assume the debt of Company A, either presently or in a planned future transaction.
- The proceeds of a debt or equity offering of Company B will be used to retire all or a part of Company A's debt.
- Company B guarantees or pledges its assets or stock as collateral for Company A's debt.

It is not unusual for a parent company to spin off multiple entities as part of a single transaction. In this instance, management should consider that multiple entities may guarantee the parent's transaction-related debt. Although SAB Topic 5.J contemplates a situation involving one subsidiary, the SEC staff has noted that the guidance may be applied to multiple direct guarantor subsidiaries. Specifically, at the 2008 AICPA National Conference on Current SEC and PCAOB Developments, Robert Fox III, an SEC professional accounting fellow, stated, in part:

> We do not believe that SAB Topic 5J should be interpreted to only apply to situations where one subsidiary is acquired. When a subsidiary, whether directly owned by the parent or not, is to assume the parent's debt, the proceeds will be used to retire all or a part of the parent's debt, or if the subsidiary guarantees or pledges its assets as collateral for the parent's debt, acquisition related debt should be pushed down to all acquired subsidiaries.

An entity should consider the following factors when applying this guidance:

- Parent-company debt is jointly and severally, as well as fully and unconditionally, guaranteed by the carve-out entities and additional entities remaining with the parent.
- Each of the carve-out entities individually pledged its real estate assets as collateral for the parent debt.
- The parent company is a holding company, and its debt is serviced strictly from the cash flows generated by the carve-out entities and remaining entities.

Editor's Note: The EITF recently finalized a project that addresses how a reporting entity should account for joint-and-several obligations when the total amount of the obligation is fixed as of the reporting date. Specifically, the Task Force was asked whether each obligor that is jointly and severally liable should (1) recognize the total obligation, (2) account for the total obligation as a guarantee that is within the scope of ASC 460, or (3) account for the total obligation as a contingent liability that is within the scope of ASC 450-20. At the EITF's January 2013 meeting, the Task Force affirmed and clarified its July 2012 consensus-for-exposure that each reporting entity that is jointly and severally liable should measure its portion of the total obligation as the amount it has agreed to pay among co-obligors plus the amount an entity expects to pay on behalf of the other co-obligors, considering the measurement (not the recognition) guidance in ASC 450-20. The Task Force affirmed and clarified its proposed disclosure requirements for joint-and-several obligations within the Issue's scope. Entities will be required to disclose, among other items, a description of the joint-and-several arrangement and the total outstanding amount of the obligation for all joint parties. The disclosure requirements were clarified to permit aggregation of disclosures (as opposed to separate disclosures for each joint-and-several obligation) and to refer to the existing related-party disclosure requirements in ASC 850.

This Issue will be effective for public entities for all prior periods in fiscal years beginning on or after December 15, 2013 (and interim reporting periods within those years). For nonpublic entities, the Issue will be effective for the first annual period ending on or after December 15, 2014, and interim and annual periods thereafter. This Issue will be applied retrospectively to obligations with joint-and-several liabilities existing at the beginning of an entity's fiscal year of adoption. Entities that elect to use hindsight in measuring their obligations during the comparative periods will be required to disclose that fact. Early adoption will be permitted.

Goodwill and Other Intangible Assets

When preparing carve-out financial statements, management must consider any goodwill amounts that the parent attributes to the carve-out entity. Because the intent of carve-out financial statements is to segregate transactions within the parent's financial statements that are specifically related to the carve-out entity, any historical goodwill amounts attributed to the carve-out entity would be included and disclosed in the carve-out financial statements.

Complexities can arise if the carve-out entity represents only a portion of a (1) previously acquired business or (2) reporting unit. If such a carve-out entity constitutes a business (as defined in ASC 805-10-55), the parent must use a reasonable allocation method to determine the amount of goodwill from the reporting unit to allocate to the carve-out entity. When preparing the financial statements of a carve-out entity, management may apply the guidance in ASC 350-20-40-3 on disposal of an entity to determine the amount of goodwill to allocate from a reporting unit on the basis of "the relative fair values of the business to be disposed of and the portion of the reporting unit that will be retained." Neither ASC 350 nor ASC 360 requires or prohibits a revision of the goodwill allocation as of the date of "sale" to reflect changes in the relative fair values of the businesses to be disposed of and the portion of the reporting unit that will be retained. Nevertheless, if management has reason to believe that there has been a significant change in the relative fair values, a revision of the goodwill allocation is recommended but not required.

Identifying Operating Segments and Reporting Units

Management should consider that the carve-out entity's operating segments may differ from those identified in the parent company's reporting structure. An operating segment has the following characteristics:

- The segment earns revenue and incurs expenses from participating in business activities.
- The CODM reviews operating results to assess performance and makes decisions about resources to be allocated to the segment's operating results.
- Discrete financial statement information about the segment is available.

To identify each operating segment, a parent should consider its characteristics with respect to the specific carve-out entity. The CODM is the person or function that will be responsible for reviewing the discrete segment financial statement information going forward. In addition, the discrete financial statement information for the carve-out may be different from that used for the segment reporting related to the consolidated parent's historical financial statements. Management must carefully evaluate the carve-out entity's facts and circumstances to appropriately identify its operating segments.

Determining the carve-out entity's operating segments is the first step in identifying the reporting units to which goodwill should be allocated in the carve-out entity's structure. Management would evaluate components of an operating segment to determine whether the components have similar economic characteristics and thus should be aggregated into a single reporting unit. This evaluation may result in reporting units for the carve-out entity that differ from what was identified in the parent's reporting structure.

Example

A sports equipment company prepares discrete financial information by type of sport (i.e., basketball, golf, baseball, and hockey); this information is regularly reviewed by the chief executive officer (who is deemed to be the CODM). These four sport types are determined to each represent a reporting unit, which is tested annually (or more frequently if certain conditions exist) for impairment. The parent company decides to carve out its basketball reporting unit, which it had previously acquired and to which it had attributed $10 million of goodwill. As the company begins to prepare the carve-out entity's financial statements, it determines that the basketball CODM will be the segment manager as of the effective date of the divestiture. The basketball CODM will review financial data divided into the following components: basketball equipment, basketball clothing, and basketball shoes. The company determined that these three components will represent its operating segments. Because the basketball clothing and shoes are deemed to have similar economic characteristics, these operating segments will be aggregated into one reportable segment. Therefore, when preparing the carve-out entity's financial statements, the company would allocate the historical goodwill ($10 million) attributed to the basketball division between its three reporting units in the two new reportable segments.

Goodwill Impairment Testing

If management previously performed a goodwill impairment test during the historical years presented in the carve-out entity's financial statements, it may not be required to reperform the impairment test when preparing the carve-out entity's financial statements even if different reporting units were identified. However, if the parent company has not historically performed a goodwill impairment test (e.g., the carve-out operations were part of a recent acquisition), it must perform the test for each reporting unit identified in the carve-out entity by using historical assumptions and projections as of the date of the assessment period.

Parent-Company Considerations

When a decision is made to sell a reporting unit or portion thereof, management may need to perform a goodwill impairment analysis between its annual impairment tests. If an impairment test is deemed necessary, management could elect to perform a qualitative assessment and evaluate whether the carve-out transaction would more likely than not reduce the fair value of a reporting unit below its carrying amount. If so, management would be required to perform an impairment assessment and consider the guidance in ASC 350-20-40-7, which states:

> When only a portion of goodwill is allocated to a business to be disposed of, the goodwill remaining in the portion of the reporting unit to be retained shall be tested for impairment . . . using its adjusted carrying amount.

Disclosure Considerations

A carve-out entity's financial statements that include goodwill must meet the disclosure requirements in ASC 350-20-50-1 for presenting changes in the carrying amount of goodwill. Under these requirements, an entity must separately disclose:

> a. The gross amount and accumulated impairment losses at the beginning of the period
> b. Additional goodwill recognized during the period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with paragraph 360-10-45-9
> c. Adjustments resulting from the subsequent recognition of deferred tax assets during the period in accordance with paragraphs 805-740-25-2 through 25-4 and 805-740-45-2
> d. Goodwill included in a disposal group classified as held for sale in accordance with paragraph 360-10-45-9 and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale
> e. Impairment losses recognized during the period in accordance with [ASC 350]
> f. Net exchange differences arising during the period in accordance with Topic 830
> g. Any other changes in the carrying amounts during the period
> h. The gross amount and accumulated impairment losses at the end of the period.

To meet the above disclosure requirements, management may have to allocate amounts previously presented in the parent-company financial statements for these various components that changed the carrying amount of the carve-out entity's allocated goodwill. This may be challenging if the parent company has historically presented changes in the goodwill carrying amount in the aggregate rather than by reportable segment (as is the case with entities that are not within the scope of ASC 280).

Other Long-Lived Assets: Impairment Testing

For all other long-lived assets (e.g., property, plant, and equipment), entities should use a reasonable allocation method. In addition, entities must consider impairment. Under ASC 360, an entity must test long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. Impairment losses should be recognized if the carrying amount of a long-lived asset (or its related asset group) (1) is not recoverable on the basis of projections of future undiscounted cash flows and (2) exceeds its fair value.

Although a carve-out transaction is not an explicit trigger for recoverability testing, the carve-out entity's reporting units (and subsidiaries within each unit) may have been reorganized in preparation of the carve-out financial statements. To the extent that the asset groups have changed, an entity may be required to test that asset group for impairment. However, as with the assessment of goodwill impairment, management may not use hindsight in evaluating triggering events for possible signs of impairment. See the Goodwill and Other Intangible Assets section for more information.

Editor's Note: When required to test both goodwill and long-lived assets for impairment, an entity would first perform the long-lived asset impairment test to determine whether any change in the carrying amount of those assets is necessary and would then perform the goodwill impairment test. This sequence is based on the principles in ASC 845-10-30, which notes that the carrying amount of the carve-out assets should be based on their historical cost, after reduction for any applicable impairment.

Other Assets and Liabilities

For all other assets and liabilities, specific guidance does not exist; therefore, entities should use a reasonable allocation method. However, because the facts and circumstances vary depending on the types of assets or liabilities that need to be presented in the carve-out financial statements, management must evaluate each of these financial statement items individually to ensure that the allocation method is reasonable. This section provides a few examples of such items as well as considerations related to developing an appropriate allocation method.

Working Capital

Companies often have centralized cash management functions involving "sweep" accounts as well as centralized cash collection and bill payment centers. When the customers and vendors of the carve-out entity overlap with those of its parent, it can be burdensome to identify relevant receivables and payables. In these situations, management should develop a "system" solution early on in the carve-out process. For example, finding a way to isolate individual SKUs and allocate shipping and tax charges appropriately is often critical to developing a set of financial statements that can withstand the rigors of an audit.

Deferred Compensation

For deferred compensation plans, management must determine whether to allocate those balances or a portion thereof to the carve-out entity. The deferred compensation balances generally should "follow the employee" to whom they relate. In many cases, these balances are related to the executives. Accordingly, management should consider where the executive will be employed once the carve-out transaction is completed. Management should also consider historical allocations of compensation expense. For example, if the company had previously allocated a portion of overall compensation expense to a segment that is being carved out, a similar portion of compensation should also be allocated to the carve-out financial statements.

Guarantees and Indemnification Liabilities

Carve-out financial statements should reflect all guarantee and indemnification liabilities for which the carve-out entity is the primary obligor. Management should consider all details of such arrangements, especially intercompany guarantee and indemnification agreements, to determine whether the associated liability should be included in the carve-out financial statements.

Self-Insurance Accruals

Self-insurance accrual allocations can be complex and generally require the involvement of an actuary. If the parent company maintains sufficient claim detail, management may be able to identify the specific claims base attributable to the carve-out entity. For example, if a parent company is carving out five plants, management may be able to use "plant identifiers," such as a company code, to identify the specific claims associated with the five plants. However, if a parent company does not have sufficient detail in its claims data to identify the claims attributable to the carve-out entity, management would need to determine an appropriate allocation method to estimate the amount. Allocation methods may take into account such factors as payroll exposure data and percentage of headcount associated with the carve-out entity.

Editor's Note: Management should select methods that are consistent with previous analyses. In other words, the claims reserve allocation also should be consistent with the method by which the historical self-insurance expense has been allocated to the carve-out operations.

Contingencies

Contingent liabilities (e.g., legal or environmental) may be recorded in the historical financial statements of the parent company's consolidated group, and an intercompany balance may have been recorded when one party indemnifies the other party. For such liabilities, management should consider whether the carve-out entity or the parent company would ultimately be responsible for the obligation to settle them. For example, if the carve-out entity legally indemnifies the parent company for the liability, the contingent liability should be recorded in the carve-out entity's financial statements. In addition, when the carve-out entity creates a contingency and the parent company agrees to assume the liability on a post-carve-out-transaction basis, the liability and related expense would most likely be allocated to the carve-out entity's financial statements.

Defined Benefit Plans

In some cases, employees of the carve-out entity participate in one or more defined benefit plans that are sponsored by the parent entity (or another entity in the consolidated group that is not part of the carve-out entity). While there is no specific guidance on accounting for such benefit plans in the carve-out financial statements, entities can choose one of two acceptable methods: (1) a multiemployer approach or (2) an allocation approach. Under either approach, the carve-out entity's income statement should reflect an allocated portion of the net periodic benefit cost based on a reasonable allocation method. The key difference between the two approaches is whether an allocation of the plan's benefit obligation, plan assets, and related AOCI balances is included in the carve-out entity's balance sheet. The method chosen should be appropriately disclosed in the carve-out financial statements.

Multiemployer Approach

Under a multiemployer approach, the carve-out entity would analogize to the guidance in ASC 715-80-35-1 on multiemployer plans, as further described in ASC 715-30-55-62 through 55-64. This guidance describes accounting similar to the accounting a subsidiary would use in its stand-alone financial statements if it participates in a defined benefit plan sponsored by the parent entity for which the plan assets are not segregated and restricted for each participating subsidiary. This approach would **not** reflect the carve-out entity's share of the benefit obligation, plan assets, and related AOCI amounts in the carve-out balance sheet. An intercompany payable or receivable may be included in the carve-out balance sheet, depending on the historical approach an employer has used when allocating benefit costs or funding the plan. Under this approach, if the carve-out entity will assume responsibility for a portion of the plan's benefit obligation, the financial statements should disclose either the benefit obligation and plan assets to be allocated to the stand-alone entity or, if that information is not available, the information available for the plan's aggregate benefit obligation and plan assets before the carve-out transaction.

Allocation Approach

Under an allocation approach, the carve-out entity would reflect its portion of the benefit obligation, plan assets, and any related AOCI amounts on the carve-out balance sheet. This approach may be more helpful to financial statement users because the carve-out financial statements would include the amount of the benefit obligation to be assumed by the carve-out entity (and, hence, to be carried forward into future financial statements and operating results). In accordance with ASC 845-10-55-1, if a pension obligation is being transferred as part of a spin-off, an entity must account for such a transfer similarly to how it accounts for a division of a pension plan that was previously part of a larger pension plan. For both pension and other postretirement defined benefit plans, it is appropriate for an entity to analogize to this guidance when preparing a carve-out balance sheet.

Example 1 in ASC 845-10-55-3 through 55-9 illustrates this approach. Allocation of both the benefit obligation and unamortized prior service cost should be based on the individual plan participants for whom the carve-out entity is assuming a benefit obligation. Net gain or loss and any transition asset or obligation included in AOCI are allocated in proportion to the benefit obligations (1) being assumed by the carve-out entity and (2) staying with the consolidated entity. Any allocation of plan assets is usually determined in accordance with the sale or spin-off transaction agreement and may be subject to regulatory requirements such as the Employee Retirement Income Security Act of 1974 (ERISA). The allocation approach used in preparing the carve-out financial statements should reflect the terms of any such agreement.

Other Considerations

In the case of legal plan separations in the United States, ERISA includes explicit guidance on how the plan assets must be allocated. These calculations may take a significant amount of time, so it may be necessary for an entity to make a preliminary allocation estimate for the carve-out financial statements before finalizing the ERISA calculations. If a preliminary allocation is used, the carve-out financial statements should include a prominent disclosure stating this fact.

An entity should consider whether it is appropriate to highlight this preliminary estimate in the significant risk and uncertainty disclosure required by ASC 275-10-50, since the amount recorded in the financial statements and the finalized ERISA allocation could be materially different. Once the legal separation occurs, the plan asset balances would be adjusted in subsequent-period financial statements to the actual amount of plan assets allocated to the carve-out entity.

The parent company should also consider whether, in connection with the potential sale of a business, a curtailment has occurred that should be reflected in the parent's income statement. In addition, if the parent company determines that a defined benefit plan will be settled or terminated as a result of the carve-out transaction, the accounting impact of such settlement or termination should be included in the parent's financial statements when it occurs.

Derivatives and Hedging

Management needs to evaluate all derivative instruments, regardless of whether they are designated in a hedging relationship, for possible inclusion in the carve-out financial statements. In performing this evaluation, an entity should consider whether a derivative instrument is directly attributable to the carve-out entity.

Generally, if a derivative instrument hedges an item that has been allocated to the carve-out financial statements (e.g., an interest rate swap that hedges debt included in the carve-out financial statements), the derivative instrument should also be included in the carve-out financial statements. Similarly, if a seller intends to novate a derivative instrument to the carve-out entity, that instrument should generally be included in the carve-out financial statements.

The accounting for derivative instruments allocated to the carve-out financial statements will generally mirror the accounting historically applied by the parent company. For example, if a derivative instrument qualifies for hedge accounting in the parent company's historical financial statements, hedge accounting (including any related OCI balances for cash flow hedges) should also be carried forward to the periods presented in the carve-out financial statements. In all cases, the accounting should give users of the carve-out financial statements the best possible view of the historical activity and prospective operations of the carve-out entity.

Editor's Note: After the carve-out transaction, the carve-out entity will also need to address whether it should continue to apply hedge accounting (if applicable). In performing that assessment, the entity should consider the following questions:

- Does the carve-out entity want to continue applying hedge accounting?
- Have hedging instruments been successfully novated to the carve-out entity?
- Does the carve-out entity still retain exposure to the hedged item?
- For hedges of forecasted transactions, is it still probable that the forecasted will occur after the carve-out transaction?
- For hedges of foreign-currency risk, has the carve-out transaction resulted in a change to the carve-out entity's functional currency?

Section 2 — Accounting Considerations Related to a Carve-Out Entity's Statement of Comprehensive Income

As with its balance sheet approach, in preparing carve-out financial statements, management can work through most parts of the historical income statement line by line. Because revenue is typically what defines a business, it should be relatively simple to determine the allocation of revenue amounts to the carve-out entity's financial statements. However, the existence of historical intercompany revenues or related-party transactions may increase the complexity of this determination.

The next step, allocating expenses to the carve-out entity, may prove more difficult for management. The SEC staff separates expenses into two categories: (1) expenses directly related to revenue-producing activities (e.g., costs of sales, SG&A, distribution, marketing, and R&D costs) and (2) indirect expenses (e.g., corporate overhead, interest, and taxes). The allocation of direct expenses should be straightforward since most of these expenses will be allocated to the carve-out financial statements along with the related revenues. The allocation of indirect expenses, including expenses incurred by the historical parent on behalf of the carve-out entity, may be more difficult because the historical allocation may not be clearly defined.

SAB Topic 1.B

Because there is limited authoritative guidance on the allocation of expenses, the SEC staff addressed this topic in SAB Topic 1.B (codified in ASC 225-10-S99), which may be applicable by analogy. The staff believes that all costs of doing business, including both direct and indirect expenses, should be reflected in the historical carve-out financial statements. For those indirect expenses that are not specifically identifiable, the staff encourages management to develop a reasonable allocation method in which the indirect expenses can be attributed to the carve-out entity. Management must disclose details related to the methods used for all expense allocations as well as an assertion regarding why the method chosen is reasonable. Questions 1 and 2 of SAB Topic 1.B state:

> **Facts:** A company (the registrant) operates as a subsidiary of another company (parent). Certain expenses incurred by the parent on behalf of the subsidiary have not been charged to the subsidiary in the past. . . .
>
> **Question 1:** Should the subsidiary's historical income statements reflect all of the expenses that the parent incurred on its behalf?
>
> **Interpretive Response:** In general, the staff believes that the historical income statements of a registrant should reflect all of its costs of doing business. Therefore, in specific situations, the staff has required the subsidiary to revise its financial statements to include certain expenses incurred by the parent on its behalf. Examples of such expenses may include, but are not necessarily limited to, the following (income taxes and interest are discussed separately below):
>
> 1. Officer and employee salaries,
> 2. Rent or depreciation,
> 3. Advertising,
> 4. Accounting and legal services, and
> 5. Other selling, general and administrative expenses.
>
> When the subsidiary's financial statements have been previously reported on by independent accountants and have been used other than for internal purposes, the staff has accepted a presentation that shows income before tax as previously reported, followed by adjustments for expenses not previously allocated, income taxes, and adjusted net income.

Question 2: How should the amount of expenses incurred on the subsidiary's behalf by its parent be determined, and what disclosure is required in the financial statements?

Interpretive Response: The staff expects any expenses clearly applicable to the subsidiary to be reflected in its income statements. However, the staff understands that in some situations a reasonable method of allocating common expenses to the subsidiary (e.g., incremental or proportional cost allocation) must be chosen because specific identification of expenses is not practicable. In these situations, the staff has required an explanation of the allocation method used in the notes to the financial statements along with management's assertion that the method used is reasonable.

In addition, since agreements with related parties are by definition not at arms length and may be changed at any time, the staff has required footnote disclosure, when practicable, of management's estimate of what the expenses (other than income taxes and interest discussed separately below) would have been on a stand alone basis, that is, the cost that would have been incurred if the subsidiary had operated as an unaffiliated entity. The disclosure has been presented for each year for which an income statement was required when such basis produced materially different results.

Expense Allocation

Corporate expenses — including those related to executive management, IT, tax, insurance, accounting, legal and treasury services, and certain employee benefits — that may have historically been allocated by the parent company to the carve-out operations should be included in the financial statements of the carve-out entity. These expenses may have been allocated on the basis of projected or actual revenues, employee headcount, net sales, or other factors. As discussed in the SAB Topic 1.B section, management needs to disclose the allocation methods being used in the carve-out financial statements and state that the allocations are reasonable. In addition, management should consider the following when addressing these historical allocations:

- If the expenses are allocated on the basis of forecasted amounts, whether the allocations need to be updated on the basis of actual results.
- The expenses recorded in the historical carve-out financial statements should reflect a reasonable allocation of the parent's historical costs, even though such costs may not reflect the actual expenses that would have been incurred had the carve-out entity been operating as a separate, stand-alone public company for the periods presented.
- Corporate allocation of expenses may have been historically recorded as intercompany revenues and expenses that were eliminated upon consolidation.

Each carve-out transaction and the related financial statements will present unique challenges for management. The allocation of indirect expenses may prove one of the most difficult aspects of preparing the carve-out financial statements.

Editor's Note: Carve-out entities often enter into various post-transaction-related agreements with the parent entity (e.g., tax-sharing agreements or transition-services agreements that may include HR-related functions). After separation, these agreements may have a considerable impact on the carve-out entity's financial results. For example, overhead-related expenses "allocated" from the parent entity via these new agreements may differ from historical corporate allocations included in the carve-out financial statements.

Intercompany Transactions

Because the intent of carve-out financial statements is to isolate transactions related to the business that will be carved out, preparers must (1) identify the types of intercompany transactions that have historically occurred between the carve-out entity and the remaining entities and (2) determine how those transactions and related account balances will be presented in the carve-out financial statements. Although these transactions were originally eliminated in consolidation of the parent entity's financial statements, they generally should not be eliminated from the carve-out financial statements (unless the intercompany transactions take place among subsidiaries within the carve-out entity). To properly account for intercompany balances, an entity must determine when the intercompany payables, receivables, and notes will be settled (either before or after the transaction) and by what means (e.g., cash payment or via an equity contribution). For example, it is not uncommon for a parent company to forgive certain intercompany balances (such as certain intercompany payables); such balances would therefore not result in cash settlement. Consequently, such forgiven amounts are accounted for as equity contributions in the carve-out financial statements. Conversely, balances that are expected to be settled in cash are reflected as "due to" or "due from" the parent company in the carve-out financial statements.

Editor's Note: Management should consider whether the controls in place for the parent entity are sufficiently precise to cover the transactions at an intercompany level. For example, if certain transaction codes are used to identify intercompany sales, management should consider whether the consolidated group has controls over the master data inputs and changes to that transaction code field, which would ensure that the identification of intercompany amounts is complete and accurate.

In addition, management should consider granular transaction-level detail in the preparer's systems of record (as opposed to "batched" information, which may not retain all detail related to certain intercompany transactions) to ascertain the nature of certain intercompany balances from a cash flow perspective (e.g., if intercompany cash transfers are recorded in a net intercompany payables account, there may be no visibility into gross borrowings and payments).

Intercompany amounts to consider include, but are not limited to, (1) receivables, payables, notes, and dividends between the remaining entities and the carve-out entity and (2) intercompany sales, costs of goods sold, royalty revenues, and management fees. Particular care must be taken to ensure that these items are properly classified and accounted for by the carve-out entity, regardless of the manner in which these amounts are historically captured in the consolidated group's system (since such amounts were most likely eliminated during consolidation).

Share-Based Payment Awards

Carve-out financial statements should reflect all stock compensation expense attributable to the carve-out entity. The associated expense may be specifically identifiable to a stock compensation plan or allocated to the carve-out entity. If a stock compensation plan is directly attributable to the carve-out entity (e.g., the carve-out entity is a separate legal entity with its own stock compensation plan), the related stock compensation expense should be included in the carve-out financial statements. Otherwise, an allocation is required.

If stock compensation information is available at the individual-employee level, the allocation of the expense should be fairly straightforward — that is, the amount allocated is based on the amount of expense attributable to employees assigned to the carve-out entity. However, if stock compensation is tracked at a higher level, or if the seller needs to allocate "overhead" stock compensation expense to the carve-out entity (e.g., expense related to employees that spend only a portion of their time on the carve-out entity's business), a reasonable and supportable allocation method should be used (see the SAB Topic 1.B section for further discussion). As with its allocation of cash-based compensation to employees, management's allocation of share-based compensation might take into account (1) percentage of total headcount, (2) percentage of employees' time spent working on the business of the carve-out entity, and (3) percentage of total sales (or earnings).

Editor's Note: Management typically uses the same method to allocate share-based compensation as it uses to allocate cash-based compensation in the carve-out financial statements.

In addition, the notes to the carve-out financial statements must comply with all stock-compensation-related disclosure requirements in ASC 718. For a carve-out of a separate legal entity with its own stock compensation plan, the carve-out entity should present its ASC 718 disclosures at the level of its own plan. For situations in which stock compensation was allocated to the carve-out entity, the carve-out entity is likely to present in its financial statements the parent's consolidated stock compensation disclosures instead of carve-out level disclosures that are derived, for example, from (1) an allocation or (2) a recalculation of stock compensation expense (which would most likely be performed on the basis of assumptions that differ from those used by the parent company in its historical financial statements).

Modifications to Awards

In contemplation of a carve-out transaction, management may choose to modify stock compensation awards. If awards are modified, the parent entity must apply ASC 718's guidance on award modifications and must consider the following questions:

- Does the award modification result in the recognition of incremental compensation expense?
- If incremental compensation expense is recognized, how much (if any) should be allocated to the carve-out entity?

Editor's Note: In contemplation of a carve-out transaction, an entity may decide to add a nondiscretionary, antidilution provision to its stock awards. However, an entity that adjusts the terms of an award to maintain the holder's value in response to an equity restructuring (e.g., a spin-off) could trigger the recognition of significant compensation cost if (1) the adjustment is not required under the existing terms of the award and (2) the provision that requires an adjustment is added in contemplation of the transaction. If an entity does not contemplate an equity restructuring when it adds an antidilution provision, no incremental compensation cost is recorded. In such cases, the entity should review the terms of its awards (plans) to make a legal determination about whether an adjustment is required in the event of an equity restructuring.

Note that the addition of an antidilution provision to a stock option plan may also result in unintended tax consequences and could be considered a disqualifying event of an incentive stock option. An entity should consult with its tax professionals regarding the tax implications before making changes to its stock option plans.

Incremental Compensation Expense

To calculate the amount of incremental compensation expense (if any) to recognize as a result of a modification, an entity would compare the fair-value-based measure of the award immediately before the modification with the fair-value-based measure of the award immediately after the modification. The fair-value-based measure of the award immediately before the modification will be determined on the basis of the premodification assumptions (e.g., stock price, volatility, expected dividends, risk-free interest rate), and the fair-value-based measure after the modification will be determined on the basis of the postmodification assumptions.

Accelerated Vesting and Allocation of Incremental Expense

For share-based payment awards that are accelerated in connection with a carve-out (e.g., through either a modification or a change-in-control provision), questions have arisen regarding whether any of the expenses associated with accelerating the awards (i.e., incremental expenses) should be allocated to the carve-out financial statements. The answer to such questions generally depends on whether the acceleration expense is viewed as more akin to a parent company's selling cost or to an ongoing cost of the carve-out entity's business. If the former, the cost would generally not need to be allocated to the carve-out entity. Management will need to exercise significant judgment in making that determination. In addition, we recommend that management disclose its conclusion and the reasons supporting it in its carve-out financial statements.

Valuation Assumptions

On a post-carve-out-transaction basis ("day 2") — for example, after consummation of a sale or spin-off transaction — management should consider whether the historical assumptions reflected in the carve-out financial statements continue to be appropriate for the carve-out entity's ongoing operations. For example, the assumption regarding historical attrition may need to be revised if the historical attrition rate of the employees assigned to the carve-out entity significantly differs from the historical attrition rate used for the parent entity.

Editor's Note: If an award is modified in connection with the spin-off of the carve-out entity from its parent, the fair-value-based measure of the award after the modification or spin-off will be determined on the basis of the assumptions that exist immediately after the modification/spin-off. In performing this calculation, the parent entity may need to use assumptions derived from peer groups of the carve-out entity because historical information may not be available.

APIC Pool

For share-based payment arrangements, prior excess tax benefits arising from equity-classified awards are commonly referred to as an "APIC pool." The determination of whether the APIC pool should be allocated to the carve-out entity's financial statements depends on the nature of the disposition of the carve-out entity.

Disposition by Sale

When a carve-out entity is sold, any existing excess tax benefit related to awards granted in the parent company's equity remains in the parent's consolidated APIC pool; that is, no portion of the APIC pool is allocated to the carve-out financial statements.

Disposition by Spin-Off

Regarding spin-offs, there are two acceptable methods. The first view is that the APIC pool should "follow the employee." For example, assume that the parent company spins off a subsidiary. As part of the spin-off, excess tax benefits resulting from awards in the parent's equity, exercised by the spinnee's (i.e., subsidiary's) employees before the spin-off, are allocated to the spinnee. However, excess tax benefits created by exercises made by employees who are not spinnee employees are not allocated to the spinnee as part of the spin-off.

An alternative view is that excess tax benefits "follow the entity" that issued the equity awards. That is, none of the APIC pool is allocated to the carve-out entity. Accordingly, the carve-out entity's APIC pool would be zero if all awards were based on the stock of the parent.

Exit or Disposal Costs

In preparing for a carve-out transaction, management will often restructure portions of the business, including the carve-out entity, and incur exit or disposal costs before the transaction occurs. An entity will need to determine how such costs should be reflected in the carve-out financial statements because, in some cases, the costs may not have been "pushed down" to the financial records of a subsidiary.

The SEC staff believes that carve-out financial statements should reflect all of the carve-out entity's costs of doing business. As in all instances in which costs are not specifically attributable to the carve-out entity, entities should apply a consistent method when allocating exit or disposal costs. (For further discussion of the use of a consistent allocation method to allocate costs, see the SAB Topic 1.B section.) To the extent that exit costs are related to the carve-out entity's legacy employee costs, they should be included in its historical results. However, exit costs that are related to shared costs, such as leases, should be allocated by using the same method applied to allocate the related lease expense to the carve-out entity.

When an entity enters into a restructuring plan resulting in exit or disposal costs in connection with a carve-out, it should use the same logic as it does to record historical costs. Costs that are directly attributable to the carve-out entity, such as personnel-related costs, should be included in its financial statements. An entity should use the same method as that described above to allocate shared costs. Such costs should be recognized in accordance with ASC 420.

Editor's Note: Management must make estimates when allocating exit or disposal costs. When stand-alone financial statements are being prepared for the first time but were included in the consolidated results of a parent entity, management should not use hindsight in preparing carve-out financial statements. Entities should determine whether currently available information represents information that management was aware of and misapplied or information that management should have been aware of. If a material error is identified and the carve-out financial statements should be adjusted, the effect on previously issued consolidated financial statements should also be considered.

Transaction-Related Costs

Entities may incur certain transaction costs in connection with carve-out transactions, such as accounting and tax fees, legal fees, and investment banking fees. For example, if auditing fees are incurred for preparing stand-alone carve-out financial statements, these costs would be specifically related to the carve-out entity. The expenses charged to the carve-out entity should equal the direct amount incurred. The attribution of shared costs may be more challenging; such costs will need to be allocated in a manner consistent with the principles outlined in the SAB Topic 1.B section.

To the extent that bonuses are to be paid in connection with the sale or disposal of a carve-out entity, these costs need to be analyzed for timing of recognition and attribution. If bonuses (or any costs) are entirely contingent upon the closing of a transaction, entities may apply the guidance in ASC 805-20-55-50 and 55-51 by analogy.

In accordance with this guidance, the costs should not be recorded until the transaction actually closes because of the uncertainties involved in the sale of a business.

Entities may sometimes give bonuses to employees of corporate or parent entities for the successful divestiture of a carve-out entity. If employees do not work for the carve-out entity, employee costs, including transaction bonuses, should not be allocated to the carve-out entity.

Section 3 — Other Accounting and Financial Reporting Items

Income Taxes

Understanding the legal structure of the operations to be carved out is critical to determining the income tax balances that should be included in carve-out financial statements. The accounting and financial reporting information associated with the carve-out entity may be compiled differently from the information used in tax returns, which are prepared on a legal-entity basis. It is necessary, therefore, to determine which legal entities make up the business to be carved out. Management can then determine the extent to which relevant tax information exists for these legal entities and the best way to extract the data needed for the carve-out financial statements.

The relevant legal entities may include certain assets that will be carved out and certain assets that will stay behind. By identifying these assets, management can determine the best way to allocate, if necessary, the deferred-tax-related items associated with the net assets to be bifurcated. Further, by carefully examining the carve-out entity's legal-entity structure, management may be able to identify the particular jurisdictions — both state and foreign — where the carve-out entity operates. To the extent that these jurisdictions differ from the locations of the consolidated group's remaining operations, statutory tax rates and compliance with applicable tax laws may affect the carve-out financial statements. It is also important to consider the funding of the federal, state, and foreign tax liabilities because such funding may affect presentation within the carve-out financial statements.

In determining the income tax amounts to include in the carve-out financial statements, management may need to:

- Establish an inventory of temporary differences that corresponds to the assets and liabilities that are being carved out.
- Consider whether to record a valuation allowance to offset DTAs in the carve-out financial statements.
- Determine whether it is necessary to record UTBs in the carve-out financial statements.
- Identify the records that exist and whether those must be augmented to support the carve-out financial statements.

Entities will need to use an acceptable systematic and rational method, such as the separate-return method, to determine the tax provision in the carve-out financial statements. The SEC views the separate-return method as preferable. Entities that use a different method will be required to present a pro forma income statement in which the separate-return method is used. Examples of adjustments that entities may need to make in calculating the carve-out tax provision include Section 199[1] deductions, charitable contribution carryforwards, R&D credits, and foreign tax credits.

Deferred Taxes

The balance sheet for the beginning of the earliest period covered by the carve-out financial statements is a starting point for deciding on the most appropriate approach for determining deferred taxes. Options include (1) a top-down approach, in which previously reported balances are allocated, or (2) a bottom-up approach, under which a new stand-alone set of DTAs and DTLs is identified.

In some situations, it may be easy to identify the DTAs and DTLs that should be reported in the carve-out financial statements. However, when deferred tax items are not readily identifiable with the carve-out entity (e.g., a Section 263A[2] adjustment calculated on the basis of absorption percentages that are not identifiable in the carve-out context), management must use a reasonable method to allocate these deferred items (e.g., the assets to be carved out as a percentage of the consolidated total for that category of assets).

[1] Internal Revenue Code Section 199, "Income Attributable to Domestic Production Activities."

[2] Internal Revenue Code Section 263A, "Capitalization and Inclusion in Inventory Costs of Certain Expenses."

If the tax returns have already been prepared, the entity might use actual filed tax return amounts rather than estimates to build the inventory of DTAs and DTLs at a particular year-end. This approach may yield deferred assets and liabilities that differ from those previously recorded for the carve-out operations in the prior year's consolidated tax provision. This disparity results from tax-return-to-provision differences that, within the carve-out setting, will be recorded in the financial statements for the appropriate periods. Management should analyze these differences to determine whether they result from information that existed as of the date of the financial statements or from new information or developments related to the subsequent period.

Calculating and reporting DTAs associated with the entity's tax attributes (e.g., NOL carryforwards and various tax credit carryforwards) pose unique challenges in the context of carve-out financial statements. An entity should start by tracking the tax attributes and related deferred taxes associated with the legal entities that the carve-out financial statements comprise. Such attributes may be further adjusted for any allocation adjustments to pretax amounts (discussed further below) that are recorded as part of the carve-out process. Because an entity may need to make allocation adjustments to show how the carve-out entity would look if it were operating on a stand-alone basis, the ending DTA balances associated with the carve-out entity's tax attributes may not ultimately reflect the actual tax attributes that may be available for use by the carve-out entity after the carve-out transaction occurs. For such tax attributes, the adjustments made to reconcile the theoretical carve-out approach with a strict legal-entity approach would either be reflected in pro forma adjustments (if required) or recorded by the acquirer in purchase accounting. The tax footnote in the carve-out financial statements should include disclosures about (1) NOLs either produced or used by the carve-out operations and (2) whether certain tax attributes will be allocated to the carve-out operations as part of the contemplated transaction. If the tax attributes recorded in the carve-out financial statements are materially different from those actually belonging to legal entities that the carve-out group comprises (primarily resulting from carve-out adjustments), it may be necessary to add disclosures in the tax footnote to explain the differences.

Management should determine whether it is more likely than not that the carve-out entity will realize DTAs in the future. If not, it should determine an appropriate valuation allowance and allocate it ratably between the current and noncurrent DTAs. Unlike the preparation of the carve-out entity's inventory of temporary differences, the determination of whether a valuation allowance is necessary should not take hindsight into account. Therefore, the valuation allowances should incorporate the best information available as of a given historical balance sheet date.

Tax Effect of Accounting Allocation Adjustments

To comply with the SEC's requirements for carve-out financial statements, an entity may need to allocate certain transactions and balances, such as corporate overhead expenses and various contingent liability balances, to the carve-out financial statements. These adjustments may affect the tax provision calculation or the inventory of deferred tax items. Management must consider each adjustment separately to determine the appropriate tax treatment. For example:

- Adjustments such as meal and entertainment expenses allocated to the carve-out operations will give rise to a permanent difference for tax.
- Some adjustments, like those that affect contingent liabilities or intangible assets, may result in temporary differences and therefore will necessitate adjustments to the deferred tax balances.

Management should closely review pretax book income allocation adjustments that would generally correspond to temporary differences (e.g., unrealized foreign-currency gains and losses, certain equity compensation) to determine whether the corresponding balance sheet accounts are also allocated to the carve-out financial statements. Because temporary differences result from basis differences between book and tax balance sheet amounts, it may not be appropriate to book a deferred tax balance related to these items if the pretax balance sheet account (e.g., deferred compensation liability) is not also included in the carve-out financial statements. Rather, in the carve-out tax provision, it may be more appropriate to treat the income statement item similarly to a permanent difference if it would not have been currently deductible (or currently taxable).

Taxes Payable Balance

The calculated amounts of federal and state taxes payable in the carve-out financial statements are likely to differ from the amounts previously booked and paid by the legal entities that comprise the carve-out operations. Although the carve-out process involves updating financial information to present these operations on a stand-alone basis, the process would not affect previously filed tax returns or the amounts paid by those entities to the parent under a tax-sharing agreement or similar arrangement. As a result, the balances of taxes payable or receivable calculated on a carve-out basis often will not result in corresponding cash tax payments or receipts. Generally, the carve-out entity will include subsidiaries that joined in consolidated tax filings for which the parent entity funded the tax liability or collected a refund. A tax-sharing agreement may be used to dictate whether cash for taxes paid and received is collected from, or refunded to, the carve-out entity.

Management will generally prepare the tax provision for the carve-out financial statements by using the separate-return method, in which taxable income or loss is calculated as if the carve-out operations represented a taxable group that is separate from the existing parent. The balance of taxes payable or receivable should be computed in a corresponding manner. Entities generally should perform the following steps to compute the payable or receivable balance:

1. Calculate the carve-out entity's current tax expense or benefit on a separate-return basis. That result represents the amount payable or receivable that would have been recognized if the carve-out entity had existed on a stand-alone basis (i.e., the basis generally used in preparing carve-out financial statements).
2. Adjust the payable or receivable balance from step 1 above to reflect the actual cash tax payments made or received by the legal entities that make up the carve-out entity to or from other members of the consolidated group (generally the parent).
3. Generally write off any remaining payable or receivable balance to equity at the end of the year since it does not represent a true liability or asset. In certain circumstances, a carve-out entity may need to settle outstanding amounts in accordance with a tax-sharing agreement. In such cases, some remaining receivable or payable is shown until those amounts are settled or forgiven in connection with the carve-out transaction.

This approach should yield a tax expense or benefit and related payable or receivable that closely mirror the amounts that the carve-out entity can expect to pay or receive annually.

State Tax Considerations

Entities with multistate operations will have various considerations in a carve-out transaction. For example, the carve-out entity may:

- Be located in states that are different from those of the consolidated group's other operations.
- Have a portion of income taxed in a state where it does not operate because of a unitary filing requirement.
- Operate alone in a state that requires a unitary filing and therefore subject the consolidated group's income to tax in that jurisdiction.

Individual state tax rates for the carve-out entity may be different from those typically applied to the consolidated group. Entities should therefore consider the need to recalculate the apportionment for the carve-out entity on a stand-alone basis. Further, entities should consider whether the use of separate filings, instead of unitary state filings, could cause a shift in state tax rates. It may be difficult to gather the supporting information, particularly when (1) the carve-out entity is considerably smaller than the consolidated group and (2) state taxes have historically been booked at one blended state tax rate. Entities may therefore need to review past state tax returns, as well as apportionment work papers prepared for the legal entities that the carve-out entity comprises, to determine how income can be apportioned on a stand-alone basis.

International Considerations

If the carve-out entity operates globally, management should consider international tax implications, including, but not limited to, the following:

- The need to extract the carve-out entity from an existing foreign consolidated group or single legal entity.
- Identification and use of foreign jurisdiction tax attributes.
- Intercompany transactions that may be eliminated in the carve-out financial statements.
- The effects of intercompany financing transactions.
- Previous international structuring transactions.

Further, entities may need to prepare separate tax provision calculations for each material jurisdiction in which the carve-out entity operates. Doing so will allow management to apply the appropriate tax rate on a jurisdictional basis and determine the appropriate treatment of any pretax carve-out adjustments on the basis of local-country tax law.

Management should consider whether there is a need to reevaluate an indefinite reinvestment assertion related to earnings of foreign subsidiaries and whether the assertion changes because of the carve-out. Specifically, entities should review the cash requirements of the carve-out entity, previous global repatriation decisions related primarily to operations outside of the carve-out entity, and the ability to offset tax liabilities resulting from repatriation of earnings with foreign tax credits.

Unrecognized Tax Benefits

The parent company may have some UTB liabilities related to the carve-out entity, in which case the entity's consolidated balance should be considered and a reasonable approach (i.e., specific identification or allocation) should be used to assess how much of the UTB liability is attributable to the carve-out entity. The actual legal obligation for the uncertain tax position must first be considered on a legal-entity basis. Once legal obligations are determined, additional analysis may be necessary. For example, if the parent entity will retain liability for uncertain tax positions, including those related to the carve-out entity, it may be necessary to include UTBs, as well as a receivable evidenced by an indemnification agreement with the parent company, in the carve-out financial statements. If the carve-out entity gave rise to the uncertain tax position (regardless of which party bears the contractual obligation), it may be appropriate to include its impact in the carve-out tax provision. In contrast, if the carve-out entity will, as part of a tax indemnification agreement, retain liability for specific uncertain tax positions related to legal entities not included in the carve-out entity, it may be inappropriate for the change in those balances to be included in the tax provision of the carve-out entity. In this scenario, the entity may need to adjust the net parent investment in the carve-out entity to ensure that the balance sheet accurately reflects the liabilities that will exist after the carve-out transaction occurs.

Interim Updates

If the carve-out financial statements will be publicly filed, entities may need to prepare interim financial statements in addition to the annual carve-out financial statements. Generally, entities would use an estimated annual ETR (for the carve-out operations) adjusted by discrete items for the interim period. Under this approach, entities determine an interim provision in the carve-out financial statements that is likely to be comparable to the consolidated historical interim reporting. For example, as a starting point in its calculation of the interim provision, an entity would typically analyze its historical projections to determine whether they are still appropriate for the carve-out operations. In unique circumstances, however, retrospectively determining the appropriate annual ETR for interim reporting for carve-out financial statements can be particularly difficult. In these instances, an entity might consider using the actual annual carve-out financial statements as a surrogate for interim projections and then adjust the annual ETR for items that would have been accounted for discretely to determine the estimated annual ETR.

Income Taxes Footnote

Unless abbreviated financial statements are prepared for the carve-out operations, management should present a tax footnote disclosure that is consistent with the parent company's full financial statement presentation. Such disclosure should include:

- An ETR reconciliation. Operations involving multiple jurisdictions should consider whether the statutory rate is a blended rate based on those jurisdictions or a single rate based on the predominant location.
- A summary of the current and deferred tax provision.
- A schedule detailing the DTAs and DTLs.
- If necessary, a UTB reconciliation with appropriate disclosure language.

In addition to providing the various tables, management should consider using the text of the footnote to explain how certain items unique to the carve-out were treated for tax purposes. Such explanation might include:

- Comments on the legal structure and how the operations themselves are treated for tax purposes (e.g., separate return vs. consolidated group).

- Pushdown of tax attributes so that investors may consider the value that the operations will derive from using these attributes on a post-transaction basis.
- The method used to determine the payable or receivable balance.

Discontinued Operations

In certain carve-out transactions, a part of the business that was historically included in the operations of the carve-out entity may remain with the parent company upon consummation of the carve-out transaction. In addition, certain portions of the carve-out entity's operations may have been previously presented as discontinued operations in the parent company's historical financial statements. As discussed in the Identifying the Carve-Out Entity section, providing insight into management's operating history or track record is one of the ultimate goals of carve-out financial statements. Although a portion of the historical carve-out entity may not continue to be part of the carve-out entity going forward, it should be reflected in the carve-out financial statements.

In this situation, management must determine whether it should present, as a discontinued operation in the carve-out financial statements, (1) the portion of the carve-out entity being retained by the parent company or (2) portions of the carve-out entity's operations that were previously presented as discontinued operations in the parent company's historical financial statements. Management's evaluation of the specific facts and circumstances in this instance would be similar to its assessment of any potential discontinued operations. Specifically, management would consider the following two criteria in ASC 205-20-45-1 for reporting a discontinued operation:

> a. The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction
>
> b. The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

Management could also consider the implementation guidance in ASC 205-20-55-3, which outlines four steps to take in evaluating the two conditions above. Management should also consider the implications of this determination when preparing the carve-out statement of cash flows. See the Statement of Cash Flows section for further discussion.

Editor's Note: After the carve-out transaction, the parent company may be required to present the carve-out entity as a discontinued operation in the parent company's subsequent financial statements. When making this determination, the parent company would consider the guidance from ASC 205. If both criteria are met, the parent would report the carve-out entity as a discontinued operation in its financial statements. However, it would be unlikely that amounts presented as discontinued operations for the carve-out entity in the parent company's financial statements would equal the operations reflected in the carve-out entity's separate financial statements (e.g., because of differences in how expenses may have been allocated).

In certain situations, some of the carve-out entity's operations will not remain with the carve-out entity — such as in a spin-off transaction that is consummated after the historical periods of the carve-out financial statements. In addition, such "excess" operations may not meet the criteria for presentation as discontinued operations as of the date of the carve-out financial statements. However, if the carve-out entity is being spun as a public company and the excess operations were not reflected as discontinued operations, the carve-out entity would probably need to remove the excess operations in its pro forma financial statements included as part of its SEC filing. See the Pro Forma Financial Information (Article 11) section for more information about pro forma financial statement requirements.

Subsequent Events

A carve-out entity's financial statements must include subsequent-event disclosures. Because the carve-out financial statements are an extraction from the previously issued parent-company financial statements, the carve-out information should simply be a subset of the previously issued subsequent-event disclosures but are most likely subject to lower materiality thresholds for disclosure. Therefore, management only needs to identify subsequent events that apply to the operations of the carve-out entity. If new events are identified after the issuance of the parent-company historical financial statements and before the issuance of the carve-out financial statements, the carve-out financial statements may include disclosure of additional subsequent events but generally would not recognize the impact of such events (excluding identified errors). This approach is supported by analogy to the reissuance guidance in ASC 855-10-25-4, which states:

> An entity may need to reissue financial statements, for example, in reports filed with the SEC or other regulatory agencies. After the original issuance of the financial statements, events or transactions may have occurred that require disclosure in the reissued financial statements to keep them from being misleading. An entity shall not recognize events occurring between the time the financial statements were issued or were available to be issued and the time the financial statements were reissued unless the adjustment is required by GAAP or regulatory requirements. Similarly, an entity shall not recognize events or transactions occurring after the financial statements were issued or were available to be issued in financial statements that are later reissued in comparative form along with financial statements of subsequent periods unless the adjustment meets the criteria stated in this paragraph.

Events or information identified after the original issuance of the consolidated financial statements would generally not be recognized in the carve-out financial statements. However, errors identified during the development of the carve-out financial statements that meet the criteria for the correction of an error or for a prior-period adjustment should be evaluated and accounted for in accordance with ASC 250. Management should use judgment in performing such evaluation.

Segment Reporting

Under ASC 280, carve-out financial statements for public entities must include reportable segment disclosures for all periods presented. Nonpublic entities are not required to provide segment disclosures, although they are encouraged to do so.

As discussed in the Goodwill and Other Intangible Assets section, management must first determine the reporting structure and operating segments of the carve-out entity. Because the reporting structure of the carve-out entity may differ from that of the parent, the carve-out entity's operating segments could be different as well. Next, management must determine the reportable segments in accordance with the criteria in ASC 280-10-50-10, which states:

> A public entity shall report separately information about each operating segment that meets both of the following criteria:
>
> a. Has been identified in accordance with paragraphs 280-10-50-1 and 280-10-50-3 through 50-9 or results from aggregating two or more of those segments in accordance with the following paragraph
>
> b. Exceeds the quantitative thresholds in paragraph 280-10-50-12.

Because the intent of carve-out financial statements is to isolate transactions related to the carve-out entity from the parent's financial statements, the amounts used to determine the quantitative thresholds (mentioned in ASC 280-10-50-10(b) above) should include the historical amounts allocated to segments of the carve-out entity. In addition, because the operating segments and amounts allocated to each reportable segment may differ from those presented in the parent's financial statements, the carve-out entity may identify different reportable segments.

Earnings per Share

While carve-out financial statements that are prepared in anticipation of taking the carve-out entity public (e.g., by means of an IPO) may not disclose historical EPS for the periods presented, there are "day-2" considerations related to EPS after the capital structure is in place (see discussion below). Unfortunately, ASC 260 does not provide authoritative guidance on calculating basic EPS for entities that previously did not exist but represent a carve-out of another entity.

In the calculation of basic EPS for carve-out financial statements of a newly formed entity, the denominator is often based on the number of shares issued upon the formation and spin-off of the new entity. In contrast, for carve-out financial statements prepared for a wholly or partially owned subsidiary that is subsequently spun off, the denominator for each period should be based on the weighted-average number of shares historically outstanding.

The calculation of diluted EPS should take into account the dilutive effects of the carve-out entity's options from the date they are granted and ignore the parent-company options outstanding in prior periods.

Editor's Note: It is common for existing wholly owned incorporated subsidiaries to be capitalized with a nominal number of shares. At the time the subsidiary is sold in an IPO or a spin-off transaction, the number of common shares is increased significantly through a stock split. In accordance with ASC 260, an entity should retroactively adjust the outstanding shares used in computing the weighted-average shares outstanding for basic EPS for the effects of the stock split. Additional shares that are sold in the IPO transaction itself should be included in basic EPS only from the issuance date.

Statement of Cash Flows

In developing a statement of cash flows for carve-out financial statements, management must use judgment and develop estimates to determine and report various cash flow components. It may be best for management to first develop the carve-out balance sheet and income statement before developing the statement of cash flows, since most components of the cash flow statement are derived from the balance sheet accounts. For example, after management determines the proper balance sheet allocation of fixed assets to the carve-out entity, it must consider the related cash flow statement implications associated with these balances (e.g., as additions, disposals, and depreciation expense). These amounts should be extracted from the parent company's historical financial statements and would generally not be adjusted for information identified after the issuance of the parent company's financial statements unless the adjustment is required by GAAP or other regulatory guidance (see the Subsequent Events section for further discussion).

Intercompany Transactions

In most cases, the captions in the carve-out statement of cash flows will be similar to those in the parent company's cash flow statement. However, differences will most likely arise as a result of the presentation of intercompany transactions. For example, there may be differences related to (1) deemed dividends, (2) noncash transfers between the parent and carve-out subsidiaries, or (3) intercompany sales or other types of cash transfers. Management must evaluate which intercompany balances, if any, should be allocated to the carve-out entity by considering intercompany sharing agreements and the nature of the balances. This evaluation may prove challenging when the carve-out entity comprises many portions of the parent company's various affiliates or subsidiaries. Unlike a consolidated statement of cash flows, in which all intercompany transactions are eliminated, the carve-out entity's historical statement of cash flows must reflect the intercompany transactions with the parent company.

Once management determines the intercompany activity that should be reflected in the carve-out cash flow statement, it must determine the proper classification (i.e., operating, financing, or investing). For example, some consolidated entities use a centralized cash management system or cash sweep arrangements in which subsidiary cash is pooled in the parent-company bank account and swept on the basis of each subsidiary's cash requirements. Management needs to decide whether the deposits made by the carve-out entity to the central cash account should be presented as cash and cash equivalents in the carve-out financial statements. If the deposit is not a demand deposit in a bank or other financial institution or if it is not a short-term, highly liquid investment, it may not meet the definition of cash or a cash equivalent. Therefore, in such cases, it would most likely be presented in the carve-out financial statements as a receivable from or payable to the parent company.

The presentation of intercompany transfers as operating, investing, or financing will depend on the nature of the transaction. In accordance with ASC 230, cash flows from investing activities include payments and receipts related to making and collecting loans, whereas cash flows from financing activities include proceeds and payments related to borrowings and repayments of amounts borrowed. For example, if management determines that deposits made by a subsidiary to a central cash account are analogous to a loan, changes in the related receivable to the parent company should be presented as investing activities. Conversely, if a subsidiary withdraws cash from the central cash account beyond what it had initially deposited (i.e., similarly to borrowing), it may present changes in the payable to the parent company as a financing activity in the statement of cash flows.

In addition, if the carve-out entity historically engaged in various intercompany cash flow transactions, this activity may be presented net in the carve-out statement of cash flows when certain conditions exist. In determining whether such presentation is appropriate, management should consider the following questions from ASC 230-10-45-8:

- Is the turnover quick?
- Are the amounts large?
- Do the maturities have a short duration?

These questions are intended to help preparers make this determination. However, the carve-out entity should examine the facts and circumstances to select a presentation that provides the most relevant information to financial statement users.

Income Taxes

Management should also consider the effect of changes in the taxes payable balance on the statement of cash flows. Generally, the statement of cash flows includes an operating cash flow "addback" for total income tax expense and a reduction in operating cash flows for actual cash tax payments. The carve-out cash flow statement should include an equity adjustment related to cash paid for taxes to the extent that such cash taxes are settled through equity or never settled. It may be appropriate to include this equity adjustment in the financing section if the cash paid for taxes payable by the carve-out entity has historically been paid by the parent company.

Editor's Note: After the carve-out transaction, the parent company should assess whether the carve-out entity qualifies for presentation as a discontinued operation, since this could affect the parent's post-transaction presentation in the statement of cash flows. ASC 230-10-45-24 allows an entity to elect whether to present the discontinued operations separately in its statement of cash flows; such election should be applied consistently to all periods presented. See the Discontinued Operations section for more information.

At the 2005 AICPA National Conference on Current SEC and PCAOB Developments, Joel K. Levine, Associate Chief Accountant, Division of Corporation Finance, provided acceptable presentation alternatives, including (1) disclosure of the cash flows from discontinued operations separately from cash flows from continuing operations within each of the three categories (operating, investing, and financing) and (2) disclosure of cash flows pertaining to discontinued operations for each of the three categories (either in detail or net) below the section for cash flows from financing activities of continuing operations. A third acceptable alternative not discussed by the SEC staff, but one that adheres to the principles of ASC 230, is to disclose only cash flows pertaining to the operating activities of discontinued operations, either in detail or as a net cash inflow (or outflow), in the operating category of the statement of cash flows. With this alternative, there would be no breakout of cash flows from discontinued operations in the investing or financing sections. The presentation alternative selected should provide the most decision-useful information.

Accounting Policy Changes

In preparing carve-out financial statements, the carve-out entity should retain the historical accounting policies that the parent company applied to it while it was part of the parent company.

Carve-out entities are frequently spun off or sold. Because a carve-out entity is separate and distinct, the entity's management may adopt accounting policies after consummation of a spin-off transaction or sale (i.e., "day two") that differ from those that it applied while part of the former parent company. A carve-out entity's management needs to determine whether changes in accounting policy represent changes in accounting principles. Note that ASC 250-10-45-1 indicates that the following are not changes in accounting principles:

> a. Initial adoption of an accounting principle in recognition of events or transactions [that occur] for the first time or that previously were immaterial in their effect.
>
> b. Adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.

After an accounting principle is adopted, it should not be changed to account for similar types of events and transactions unless the alternative accounting principle is allowable and preferable. Consequently, if a change in accounting policy represents a change in accounting principle, the carve-out entity's management needs to justify the change as one that is preferable. In the carve-out financial statements, changes in accounting principles would need to be applied retroactively and disclosed in accordance with ASC 250. For public carve-out entities, as indicated in SAB Topic 6.G, registrants that make a material change in their method of accounting are required under Rule 10-01(b)(6) of Regulation S-X to (1) indicate "the date of and the reason for the change" and (2) obtain and file as an exhibit, in their first Form 10-Q after the change, "a letter from [their] independent accountant stating that in the judgment of the independent accountant the change in method is preferable under the circumstances of that registrant."[3]

[3] As noted in the instructions to the exhibit table from Item 601 of Regulation S-K, a registrant may also be required to provide a letter regarding a change in accounting principles ("preferability letter") in its Form 10-K. However, a registrant is not required to provide such a letter in other Securities Act or Exchange Act forms. Therefore, for example, a private carve-out entity that undergoes an IPO would not need to file its accountants' "preferability" letter with its initial registration statement. Nevertheless, it would need to justify why a material change in accounting principle is preferable.

Because this is a complex process that involves judgment, a carve-out entity should carefully consider its facts and circumstances in assessing whether an accounting policy change is a change in accounting principle. Such an assessment may include, for example, publicly available financial information about the carve-out entity (e.g., whether previous carve-out financial statements have been issued and distributed, whether a carve-out entity that was spun from a public-company registrant represents a reportable segment of its former parent). If the carve-out entity is a separate reportable segment, the entity could consider whether investors may have different financial information about the carve-out entity on a pre- and post-spin-off basis.

Editor's Note: Like carve-out entities, parent-company registrants (from which carve-out entities are derived) may need to consider a change in accounting principle. Such an evaluation may be necessary, for example, if the carve-out entity's accounting principles change and if, after the carve-out entity is sold or spun, the parent-company registrant continues to (1) consolidate the carve-out entity or (2) accounts for the carve-out entity under the equity method.

For additional discussion and interpretations of SEC reporting requirements concerning a change in accounting policy, see SAB Topic 6.G.2.b.

Section 4 — SEC Reporting Topics

Except for certain circumstances related to a carve-out entity's IPO, the topics below generally do not affect the preparation of a carve-out entity's financial statements (i.e., such topics represent "day-2" considerations). However, like other SEC registrants, carve-out entities that are planning to file a registration statement with the SEC, or that are required to file a periodic report with the SEC, may be affected. For example, financial statements included in SEC filings must comply with Regulation S-X and any applicable SEC accounting and reporting interpretations. Examples of such interpretations include those in SAB Topics 5.J and 1.B, which are discussed in Section 1 and Section 2, respectively. In addition, companies may be required to include pro forma financial information in accordance with Regulation S-X, Article 11. (See the Pro Forma Financial Information (Article 11) section below for discussion of how to apply Article 11 to carve-out financial statements.)

Other Regulation S-X rules may require a registrant to provide separate financial statements (e.g., Regulation S-X, Rules 3-05, 3-09, 3-10, and 3-16) for significant acquired entities, significant equity method investments, guarantors, and issuers that collateralize registered securities. SEC rules also dictate which annual and interim financial statement periods are required, outline audit requirements, and require additional disclosures such as a five-year table depicting selected financial data and MD&A. See the Other SEC Reporting Considerations section for additional information.

Editor's Note: The discussion below does not address reporting differences for registrants that are designated as smaller reporting companies or emerging growth companies (as defined in the Jumpstart Our Business Startups Act).

Required Financial Statements (Rules 3-01 Through 3-04)

When carve-out financial statements are to be included in an SEC filing as those of the registrant or its predecessor, management must first consider the basic financial statement requirements outlined in Regulation S-X, Rules 3-01 through 3-04. A detailed review of these rules will help management understand the type and age of financial statements and schedules that the registrant must include in the financial statements. See Section 1110 of the FRM[1] for a summary of the requirements.

Pro Forma Financial Information (Article 11)

When a carve-out entity files to become a registrant, it may need to present pro forma financial statements or other pro forma information under Article 11.

Requirements for Pro Forma Financial Information Under Regulation S-X, Article 11

Article 11 specifies the periods to be presented in the pro forma balance sheet and the pro forma income statements; pro forma statements of cash flows and shareholders' equity are not required.

Article 11 also requires an introductory paragraph that explains the objective of the pro forma financial information and accompanying explanatory notes and stipulates the criteria that must be met before adjustments can be included in pro forma financial statements.[2]

[1] SEC Division of Corporation Finance's Financial Reporting Manual.

[2] Regulation S-X, Rule 11-02(c)(2) also permits, but does not require, a pro forma presentation for the comparative interim period of the previous fiscal year. A pro forma income statement does not, however, need to be presented when the "historical income statement reflects the transaction for the entire period." In addition, see Section 3200 of the FRM for form and content considerations applicable to pro forma financial statements.

Situations in Which Pro Forma Financial Information Is Required Under Regulation S-X, Article 11

The objective of providing pro forma financial information is to allow investors to understand and evaluate the impact of a transaction by showing how that specific transaction (or group of transactions) might have affected the registrant's historical financial position and results of operations had the transaction occurred on an earlier date. Transactions that warrant Article 11 pro forma information include:

- Significant business combinations.
- Dispositions of significant portions of a registrant's business.
- Acquisitions of one or more real estate operations or properties that are significant in the aggregate.
- Roll-up transactions.
- "[O]ther events or transactions [that have] occurred or [are] probable for which disclosure of pro forma financial information would be material to investors."

Article 11 pro forma information may be required in a registration statement, a proxy statement, or a Form 8-K; however, it is not required in a Form 10-K or 10-Q. In addition to consummated transactions, a registrant will need to assess probable transactions under Article 11. A registrant's conclusion depends on several factors, including the instructions of the form in which the carve-out financial statements are filed. For example, one of the most frequent situations in which a registrant needs to provide pro forma financial information is to give pro forma effect to the registrant's financial statements for a business combination. Factors that may affect whether a registrant should present pro forma financial information in its filings to reflect a business combination include whether:

- The acquired business is significant under Rule 3-05.
- The separate financial statements of the acquired or to be acquired business must be included in the registrant's filing to the SEC.
- The transaction is reflected in the historical financial statements.

Editor's Note: For business combinations, ASC 805 also requires disclosure of certain pro forma information in the footnotes to the financial statements. Note that because the Article 11 pro forma requirements are not the same as the pro forma disclosure requirements under ASC 805, registrants need to evaluate the two sets of requirements separately.

Other circumstances in which a carve-out entity may be required to present pro forma information include situations in which the registrant:

- Terminates or revises certain agreements (such as tax or other cost-sharing arrangements) or makes other significant changes that cause the historical financial statements not to reflect the ongoing costs and operations of the carve-out entity.[3]
- Declares dividends after the balance sheet date.[4]
- Changes its capitalization at the time that the carve-out entity's IPO registration statement becomes effective or near the close of its IPO.
- Receives or applies offering proceeds under certain circumstances.
- Enters into other material transactions (or other material events occur) — for example, when the registrant (1) repays outstanding debt, (2) emerges from bankruptcy, (3) registers securities, (4) applies fresh-start accounting, or (5) reorganizes or changes its capital structure.

Distribution by Carve-Out Entity

A public carve-out entity may plan to use proceeds from its equity offering to pay distributions or fund dividends to its owners. Similarly, a subsidiary that undertakes a public offering through selling its own equity securities may plan to use its proceeds to pay dividends to its parent. When the entity plans to pay distributions to its owners or

[3] See SAB Topic 1.B.2 for additional information.

[4] Such dividends may also be declared by the registrant's subsidiary. See SAB Topic 1.B.3 for additional information.

parent and (1) the distribution is not yet reflected in its historical balance sheet (regardless of whether the dividend would be paid from offering proceeds or has been declared) and (2) such a dividend would be significant in relation to the carve-out entity's equity balance on its historical balance sheet, the carve-out entity should present a pro forma balance sheet that reflects the distribution accrual with its historical balance sheet. Any offering proceeds should not be reflected in the pro forma balance sheet.

Costs of Being a Public Entity

Registrants often ask whether the cost of being a public company should be included in pro forma financial information. Pro forma disclosure in an initial registration statement should not include the expected incremental costs of being a public company because (1) the pro forma adjustments should be directly related to the transaction and (2) it is unlikely that the estimated costs of being a public company would meet the criteria for being factually supportable.

Seed Money Balance Sheet

A carve-out entity (often through a spin-off transaction) may undertake an IPO to publicly register its equity securities. In such circumstances, a public shell company[5] is frequently formed to facilitate the IPO process. The shell company is often called a "recently organized registrant" or "newly formed registrant" because it is typically a new company that generally has been in existence for less than a year and is set up with minimal capitalization. The typical form of the IPO transaction is that the public shell company (i.e., the registrant) acquires the carve-out entity such that the carve-out entity will be legally transferred to the shell company immediately before the effective date of the IPO. Therefore, in such cases, the registrant (i.e., the public shell company) will succeed to the operations of the existing business (i.e., the carve-out entity).

When the recently organized registrant succeeds to the operations of an existing business and the transaction is not determined to be a reorganization, in addition to financial statements of the existing business (also referred to as a "predecessor"[6]), such a registrant should present its financial statements in its IPO registration statement.[7] In particular, the SEC staff has in some instances noted that such registrants have inappropriately omitted a "seed money" balance sheet, which represents the balance sheet for the period before acquisition of the carve-out entity's business. A seed money balance sheet is intended to show the registrant's capitalization because it does not have any operations before the carve-out entity is legally transferred to it.

Other SEC Reporting Considerations

Business Acquisitions

When a registrant consummates, or it is probable that it will consummate, a significant business acquisition, the SEC staff may require the filing of certain financial statements for the acquired or to be acquired business (acquiree) under Rule 3-05, in a Form 8-K, registration, or proxy statement. The following factors govern whether, and for what period, financial statements for the acquiree are required:

- Whether the acquired or to be acquired assets and liabilities meet the definition of a business for SEC reporting purposes.
- The significance of the acquired or to be acquired business. The significance is calculated on the basis of three tests: the investment (purchase price) test, the asset test, and the income test.
- Whether consummation of the business acquisition is probable or has occurred.

Registrants should carefully consider whether, in a registration statement or certain proxy statements, they have:

- Correctly determined that the acquired or to be acquired assets and liabilities meet the definition of a "business" for SEC reporting purposes. The definition of a business for SEC reporting purposes under Article 11 is not the same as the definition under ASC 805 for U.S. GAAP purposes.

[5] In accordance with Securities Act Regulation C, Rule 405, and Exchange Act Rule 12b-2, a shell company is a registrant with "[n]o or nominal operations" and one of the following: "(i) [n]o or nominal assets; (ii) [a]ssets consisting solely of cash and cash equivalents; or (iii) [a]ssets consisting of any amount of cash and cash equivalents and nominal other assets."

[6] Section 1170 of the FRM addresses the requirements for predecessor financial information.

[7] For additional information, see Section 1160 of the FRM.

- Performed the significance calculations correctly. Some of the most common mistakes are misapplications of the income test, such as excluding unusual gains or losses from the test.
- Applied Rule 3-05 to probable acquisitions whose significance is greater than 50 percent. Often, registrants have only considered Rule 3-05 for business acquisitions that have been consummated.
- Considered the cumulative significance of previously consummated individually insignificant acquisitions.[8]

Editor's Note: There may be circumstances in which a carve-out entity's former parent company is a public company and has consummated one or more business acquisitions during the periods presented in the carve-out financial statements, all or part of which is related to the carve-out operations. In such situations, the carve-out entity will need to reassess the significance of the acquisitions under Rule 3-05 on a stand-alone basis in its SEC filings (i.e., regardless of whether such acquisitions were significant under Rule 3-05 for the former parent company).

Abbreviated Financial Information

Full financial information may not always be available when the carve-out business is not a stand-alone entity and separate and distinct accounts have not been maintained. In these instances, public-company buyers may request that the SEC staff accept abbreviated financial information — that is, audited statements of assets acquired and liabilities assumed (in lieu of a full balance sheet) and statements of revenues and direct expenses (in lieu of a full statement of operations). This type of "abbreviated" presentation, however, always requires preclearance with the SEC staff and is generally an option only for target financial statement requirements in an acquisition, but not for registrant financial statement requirements, such as in an IPO or public spin-off. See Section 2065 of the FRM for SEC staff guidance on the form and content of carve-out financial statements.

Equity Method Investments

Under Regulation S-X, Rules 4-08(g) and 3-09, registrants with significant equity method investments may be required to provide summarized financial information of the investee, separate financial statements of the investee, or both. To determine whether summarized information is required under Rule 4-08(g), a registrant must perform all three significance tests: the investment test, the asset test, and the income test. Under Rule 3-09, significance is calculated for equity method investees on the basis of only two tests: the investment test and the income test. If an investee is significant, its separate financial statements must be filed in the registrant's IPO registration statement (and subsequently when it is required to file its Forms 10-K).

For its future 10-K filings, a registrant should remember the following when performing the significance tests under Rules 4-08(g) and 3-09:

- Document the tests each year. This is most common when an equity investee has been clearly insignificant in the past. In certain situations, such as a near-break-even year for the registrant or a large income or loss at the investee level, the current year's significance may change, making the equity investee significant for the first time.
- Update the tests each year. Registrants should update and reassess the significance tests for all years presented in a Form 10-K and after they report a retrospective change, such as a change in accounting principle or classification of a component as a discontinued operation.

Editor's Note: There may be circumstances in which a carve-out entity's former parent company is a public company and has an equity method investment during the periods presented in the carve-out financial statements, all or part of which is related to the carve-out operations. In such situations, the carve-out entity will need to reassess the significance of the acquisitions under Rule 3-09 on a stand-alone basis in its SEC filings (i.e., regardless of whether such acquisitions were significant under Rule 3-09 for the former parent company).

For additional SEC staff interpretations of Rules 4-08(g) and 3-09, see Section 2400 of the FRM.

[8] Section 2000 of the FRM provides SEC staff guidance on acquired or to be acquired businesses. Specifically, Section 2010 of the FRM elaborates on the definition of a business for reporting purposes as opposed to that for accounting purposes. Sections 2015, 2020, and 2025 of the FRM summarize guidance and implementation points on measuring significance of an acquired business under Rule 3-05. Section 2035 of the FRM discusses considerations regarding individually insignificant acquisitions.

Guarantees of Registered Securities

Rule 3-10 requires registrants to provide separate financial statements for each subsidiary issuer or guarantor of debt securities registered or being registered unless certain criteria are met. The information required under Rule 3-10 must be presented in registration and proxy statements and Forms 10-K and 10-Q. Therefore, a registrant should consider the requirements under Rule 3-10 if (1) the registrant registers debt and one or more of its subsidiaries guarantee the debt or (2) one of the registrant's subsidiaries registers debt and the parent company or one or more of its other subsidiaries guarantee the debt.

As noted above, Rule 3-10 contains certain exceptions under which a registrant may provide more limited financial information in lieu of full financial statements. If the registrant meets the exception criteria, it may be eligible to provide, in a footnote to the parent company's financial statements, either of the following types of modified financial information in lieu of separate financial statements:

- Condensed consolidating financial information.
- Narrative disclosures about each subsidiary issuer or guarantor.

All of the exceptions under Rule 3-10 require (1) the subsidiary issuer and guarantors to be "100 percent owned" by the registrant and (2) the guarantee to be "full and unconditional." Registrants should pay specific attention to how they meet these and other criteria necessary for the presentation of modified financial information. For example, under Rule 3-10, "100 percent owned" does not mean the same thing as "wholly owned," which is defined in Regulation S-X, Rule 1-02. The terms are therefore not interchangeable. Registrants must disclose that a subsidiary is 100 percent owned as one of the conditions for relief under Rule 3-10.[9]

The SEC staff also continues to focus on whether a guarantee is truly "full and unconditional" and has observed that typical problems registrants have had in complying with this condition include:

- Limiting or capping the guarantee amount so that the definition of "full" is not met.
- Delaying the guarantor's payment obligation in the event of the issuer's default, resulting in a guarantee that is not "unconditional."

Paragraph 2510.4 of the FRM clarifies that "an arrangement that permits a guarantor to opt out of its obligation prior to or during the term of the debt is not a full and unconditional guarantee." For example, certain subsidiary guarantee release provisions that are common in high-yield debt offerings and that have the effect of releasing a subsidiary's guarantee when specified events occur are not "full and unconditional" because the guarantee must be in force throughout the term of the registered debt. However, a subsidiary whose guarantee is released automatically under one of the customary release provisions referred to in paragraph 2510.5 of the FRM may rely on the relief provided by Rule 3-10.

Registrants should also consider Rule 3-10(g), which applies to recently acquired subsidiary issuers or subsidiary guarantors. Under Rule 3-10(g), a registrant must provide separate financial statements of a significant subsidiary issuer or guarantor if the subsidiary's historical results have not been included in the parent's audited financial statements for at least nine months of the most recent fiscal year. To determine significance under Rule 3-10(g), a registrant should compare the net book value or purchase price (whichever is greater) of the subsidiary with the principal amount of the securities being registered. If the test result equals or exceeds 20 percent, a registrant must file separate audited financial statements for the most recent fiscal year and unaudited interim financial statements for the appropriate interim period preceding the acquisition. Often registrants fail to realize that the significance test under Rule 3-10(g) is different from the tests under Rule 3-05. Therefore, because they are mutually exclusive, financial statements may be required under Rule 3-10(g) but not under Rule 3-05, or vice versa.

If a registrant presents condensed consolidating financial information, it should use a columnar format and include certain or all of the following as applicable: (1) the parent, (2) subsidiary issuer(s) of the security, (3) subsidiary guarantor(s), (4) nonguarantor subsidiaries, and (5) consolidating adjustments. Each column should be prepared in accordance with U.S. GAAP (e.g., intercompany receivables should be shown as an asset and not as a negative long-term liability), except for investments in subsidiaries, which should be presented under the equity method of accounting, and should follow the general requirements for interim financial statements outlined in Regulation S-X,

[9] See Rule 3-10(h)(1) for further clarification of the definition of 100 percent owned.

Rule 10-01. Registrants should also provide sufficient detail about the assets, liabilities, operations, and cash flows for each of the parent, issuer, subsidiary guarantors, and nonguarantor subsidiaries, as appropriate. In addition, the condensed consolidating financial information should include a total for comprehensive income.[10]

For additional SEC staff interpretations of Rule 3-10, see Section 2500 of the FRM.

Issuers of Securities That Collateralize Registered Securities

Rule 3-16 requires a registrant to file full audited financial statements for each of the registrant's affiliates whose securities constitute a "substantial portion of the collateral" for any class of securities registered or being registered. The registrant must provide these financial statements in its Forms 10-K and certain registration statements. Registrants often look at the tests under Rules 3-10 and 3-16 as one test or related tests. However, they should be aware that these tests are performed separately and that the results must be assessed individually.

Rule 3-16 includes its own specific test (the "substantial portion of the collateral" test) and "bright-line" requirements. Unlike Rule 3-10, Rule 3-16 does not permit condensed consolidating financial information in lieu of full financial statements. Therefore, Rule 3-16 requires full audited financial statements for each affiliate whose securities constitute a substantial portion of the collateral of a security.

For additional SEC staff interpretations of Rule 3-16, see Section 2600 of the FRM.

Selected Financial Data

Item 301 of Regulation S-K requires registrants to include five years of financial information in their table of selected financial data. A carve-out entity subject to SEC reporting requirements must include such information in all SEC filings, including its initial registration statement and subsequent periodic filings, unless it obtains a waiver from the SEC's Division of Corporation Finance. In some cases, preparing five years of historical financial information on a carve-out basis may prove difficult, if not impossible. In such circumstances, registrants are encouraged to contact the SEC staff and should do so before their initial filings.

Related-Party Disclosures

Certain related-party transactions that were historically eliminated in consolidation of the parent-company financial statements may no longer be eliminated in preparation of carve-out financial statements. Certain existing business relationships with (1) the parent company, for example, or (2) subsidiaries that are not part of the carve-out transaction (including members of management and the board of directors of each) may continue after the carve-out transaction is completed and must be properly disclosed in accordance with ASC 850. In addition, for carve-out entities that become SEC registrants, management must consider the additional SEC financial reporting requirements of Rule 4-08(k) of Regulation S-X and proxy-related disclosures.

[10] See paragraph 2515.2 of the FRM for more information.

Appendix A — Glossary of Topics, Standards, and Regulations

The standards and literature below were cited or linked to in this publication.

FASB Literature

FASB Accounting Standards Codification Topic 205, *Presentation of Financial Statements*

FASB Accounting Standards Codification Subtopic 205-20, *Presentation of Financial Statements: Discontinued Operations*

FASB Accounting Standards Codification Subtopic 225-10, *Income Statement: Overall*

FASB Accounting Standards Codification Subtopic 230, *Statement of Cash Flows*

FASB Accounting Standards Codification Subtopic 230-10, *Statement of Cash Flows: Overall*

FASB Accounting Standards Codification Topic 250, *Accounting Changes and Error Corrections*

FASB Accounting Standards Codification Subtopic 250-10, *Accounting Changes and Error Corrections: Overall*

FASB Accounting Standards Codification Topic 260, *Earnings per Share*

FASB Accounting Standards Codification Subtopic 275-10, *Risks and Uncertainties: Overall*

FASB Accounting Standards Codification Subtopic 280, *Segment Reporting*

FASB Accounting Standards Codification Subtopic 280-10, *Segment Reporting: Overall*

FASB Accounting Standards Codification Topic 350, *Intangibles — Goodwill and Other*

FASB Accounting Standards Codification Subtopic 350-20, *Intangibles — Goodwill and Other: Goodwill*

FASB Accounting Standards Codification Topic 360, *Property, Plant, and Equipment*

FASB Accounting Standards Codification Topic 420, *Exit or Disposal Cost Obligations*

FASB Accounting Standards Codification Topic 450, *Contingencies*

FASB Accounting Standards Codification Subtopic 450-20, *Contingencies: Loss Contingencies*

FASB *Accounting Standards Codification Topic 460, Guarantees*

FASB Accounting Standards Codification Subtopic 715-30, *Compensation — Retirement Benefits: Defined Benefit Plans — Pension*

FASB Accounting Standards Codification Subtopic 715-80, *Compensation — Retirement Benefits: Multiemployer Plans*

FASB Accounting Standards Codification Topic 718, *Compensation — Stock Compensation*

FASB Accounting Standards Codification Topic 805, *Business Combinations*

FASB Accounting Standards Codification Subtopic 805-10, *Business Combinations: Overall*

FASB Accounting Standards Codification Subtopic 805-20, *Business Combinations: Identifiable Assets and Liabilities, and Any Noncontrolling Interest*

FASB Accounting Standards Codification Subtopic 805-50, *Business Combinations: Related Issues*

FASB Accounting Standards Codification Subtopic 845-10, *Nonmonetary Transactions: Overall*

FASB Accounting Standards Codification Subtopic 850, *Related Party Disclosures*

FASB Accounting Standards Codification Topic 855, *Subsequent Events*

FASB Accounting Standards Codification Subtopic 855-10, *Subsequent Events: Overall*

SEC Literature

SEC Staff Accounting Bulletin Topic 1.B, "Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity"

SEC Staff Accounting Bulletin Topic 1.J (SAB 80), "Application of Rule 3-05 in Initial Public Offerings"

SEC Staff Accounting Bulletin Topic 5.J, "New Basis of Accounting Required in Certain Circumstances"

SEC Staff Accounting Bulletin Topic 6.G, "Accounting Series Releases 177 and 286 — Relating to Amendments to Form 10-Q, Regulation S-K, and Regulations S-X Regarding Interim Financial Reporting"

SEC Regulation C, Rule 405, "Definition of Terms"

SEC Regulation S-K, Item 301, "Selected Financial Data"

SEC Regulation S-K, Item 601, "Exhibits"

SEC Regulation S-X, Rule 1-02, "Definitions of Terms Used in Regulation S-X (17 CFR Part 210)"

SEC Regulation S-X, Article 3, "General Instructions as to Financial Statements"

SEC Regulation S-X, Rule 3-01, "Consolidated Balance Sheets"

SEC Regulation S-X, Rule 3-02, "Consolidated Statements of Income and Changes in Financial Positions"

SEC Regulation S-X, Rule 3-03, "Instructions to Income Statement Requirements"

SEC Regulation S-X, Rule 3-04, "Changes in Other Stockholders' Equity"

SEC Regulation S-X, Rule 3-05, "Financial Statements of Businesses Acquired or to be Acquired"

SEC Regulation S-X, Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

SEC Regulation S-X, Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered"

SEC Regulation S-X, Rule 3-16, "Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered"

SEC Regulation S-X, Rule 4-08, "General Notes to Financial Statements"

SEC Regulation S-X, Rule 10-01, "10-01 Interim Financial Statements"

SEC Regulation S-X, Article 11, "Pro Forma Financial Information"

SEC Regulation S-X, Rule 11-02, "Preparation Requirements"

SEC Division of Corporation Finance's Financial Reporting Manual

- Topic 1, "Registrant's Financial Statements"
- Topic 2, "Other Financial Statements Required"
- Topic 3, "Pro Forma Financial Information (Regulation S-X Article 11)"

Securities Exchange Act of 1934, Rule 12b-2, "Definitions"

Appendix B — Abbreviations

Abbreviation	Description
AICPA	American Institute of Certified Public Accountants
AOCI	accumulated other comprehensive income
APIC	additional paid-in capital
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
CODM	chief operating decision maker
DTA	deferred tax asset
DTL	deferred tax liability
EITF	FASB's Emerging Issues Task Force
EPS	earnings per share
ERISA	Employee Retirement Income Security Act of 1974
ETR	effective tax rate
Exchange Act	Securities Exchange Act of 1934
FASB	Financial Accounting Standards Board
FRM	SEC Division of Corporation Finance's Financial Reporting Manual
GAAP	generally accepted accounting principles
HR	human resources
IPO	initial public offering
IT	information technology
MD&A	Management's Discussion & Analysis
NOL	net operating loss
OCI	other comprehensive income
PCAOB	Public Company Accounting Oversight Board
R&D	research and development
SAB	SEC Staff Accounting Bulletin

Abbreviation	Description
SEC	U.S. Securities and Exchange Commission
Securities Act	Securities Act of 1933
SG&A	selling, general, and administrative
SKU	stock keeping unit
UTB	unrecognized tax benefit

Appendix C — Glossary of Terms

This appendix includes defined terms from the glossaries of the ASC Topics cited in this Roadmap.

General Note

The Master Glossary contains all terms identified as glossary terms throughout the Codification. Clicking on any term in the Master Glossary will display where the term is used. The Master Glossary may contain identical terms with different definitions, some of which may not be appropriate for a particular Subtopic. For any particular Subtopic, users should only use the glossary terms included in the particular Subtopic Glossary Section (Section 20).

Glossary Terms

Acquirer

Note: The following definition is Pending Content; see Transition Guidance in 805-10-65-1. The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer. [FAS 141(R), paragraph 3]

Affiliate

A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity. [FAS 057, paragraph 24]

Antidilution

An increase in earnings per share amounts or a decrease in loss per share amounts. [FAS 128, paragraph 171]

Asset Group

An asset group is the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. [FAS 144, paragraph 4]

Assumptions

Estimates of the occurrence of future events affecting pension costs, such as mortality, withdrawal, disablement and retirement, changes in compensation and national pension benefits, and discount rates to reflect the time value of money. [FAS 087, paragraph 264]

Attribution

The process of assigning pension benefits or cost to periods of employee service. [FAS 087, paragraph 264]

Award

The collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single employee or to a group of employees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected terms. References to an award also apply to a portion of an award. [FAS 123(R), paragraph 10]

Business

Note: The following definition is Pending Content; see Transition Guidance in 805-10-65-1.

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. [FAS 141(R), paragraph 3] Additional guidance on what a business consists of is presented in paragraphs 805-10-55-4 through 55-9.

Glossary Terms

Cash

Consistent with common usage, cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. All charges and credits to those accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, a bank's granting of a loan by crediting the proceeds to a customer's demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made. [FAS 095, paragraph 7]

Cash Equivalents

Cash equivalents are short-term, highly liquid investments that have both of the following characteristics:

a. Readily convertible to known amounts of cash

b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year U.S. Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations). [FAS 095, paragraph 9]

Change in Accounting Principle

A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle. [FAS 154, paragraph 2]

Common Stock

A stock that is subordinate to all other stock of the issuer. Also called common shares. [FAS 128, paragraph 171]

Consolidated Financial Statements

Note: The following definition is Pending Content; see Transition Guidance in 810-10-65-1.

The financial statements of a consolidated group of entities that include a parent and all its subsidiaries presented as those of a single economic entity. [ARB 51, paragraph B1]

Control

The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise. [SOP 94-3, paragraph 20]

Curtailment (of a Postretirement Benefit Plan)

An event that significantly reduces the expected years of future service of active plan participants or eliminates the accrual of defined benefits for some or all of the future services of a significant number of active plan participants. [FAS 106, paragraph 96]

Disposal Group

A disposal group for a long-lived asset or assets to be disposed of by sale or otherwise represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. [FAS 144, paragraph 4]

Earnings per Share

The amount of earnings attributable to each share of common stock. For convenience, the term is used to refer to either earnings or loss per share. [FAS 128, paragraph 171]

Employee

An individual over whom the grantor of a share-based compensation award exercises or has the right to exercise sufficient control to establish an employer-employee relationship based on common law as illustrated in case law and currently under U.S. Internal Revenue Service (IRS) Revenue Ruling 87-41. A reporting entity based in a foreign jurisdiction would determine whether an employee-employer relationship exists based on the pertinent laws of that jurisdiction. Accordingly, a grantee meets the definition of an employee if the grantor consistently represents that individual to be an employee under common law. The definition of an employee for payroll tax purposes under the U.S. Internal Revenue Code includes common law employees. Accordingly, a grantor that classifies

Glossary Terms

a grantee potentially subject to U.S. payroll taxes as an employee also must represent that individual as an employee for payroll tax purposes (unless the grantee is a leased employee as described below). A grantee does not meet the definition of an employee solely because the grantor represents that individual as an employee for some, but not all, purposes. For example, a requirement or decision to classify a grantee as an employee for U.S. payroll tax purposes does not, by itself, indicate that the grantee is an employee because the grantee also must be an employee of the grantor under common law.

A leased individual is deemed to be an employee of the lessee if all of the following requirements are met:

a. The leased individual qualifies as a common law employee of the lessee, and the lessor is contractually required to remit payroll taxes on the compensation paid to the leased individual for the services provided to the lessee.

b. The lessor and lessee agree in writing to all of the following conditions related to the leased individual:

   1. The lessee has the exclusive right to grant stock compensation to the individual for the employee service to the lessee.
   2. The lessee has a right to hire, fire, and control the activities of the individual. (The lessor also may have that right.)
   3. The lessee has the exclusive right to determine the economic value of the services performed by the individual (including wages and the number of units and value of stock compensation granted).
   4. The individual has the ability to participate in the lessee's employee benefit plans, if any, on the same basis as other comparable employees of the lessee.
   5. The lessee agrees to and remits to the lessor funds sufficient to cover the complete compensation, including all payroll taxes, of the individual on or before a contractually agreed upon date or dates.

A nonemployee director does not satisfy this definition of employee. Nevertheless, nonemployee directors acting in their role as members of a board of directors are treated as employees if those directors were elected by the employer's shareholders or appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to nonemployee directors for their services as directors. Awards granted to those individuals for other services shall be accounted for as awards to nonemployees. [FAS 123(R), paragraph E1]

Equity Restructuring

A nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spin-off, rights offering, or recapitalization through a large, nonrecurring cash dividend. [FAS 123(R), paragraph E1]

Excess Tax Benefits

The realized tax benefit related to the amount (caused by changes in the fair value of the entity's shares after the measurement date for financial reporting) of deductible compensation cost reported on an employer's tax return for equity instruments in excess of the compensation cost for those instruments recognized for financial reporting purposes. [FAS 123(R), paragraph E1]

Fair Value

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. [FAS 157, paragraph 5]

Fair Value

The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. [FAS 123(R), paragraph E1]

Financial Statements Are Issued

Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP. (U.S. Securities and Exchange Commission [SEC] registrants also are required to consider the guidance in paragraph 855-10-S99-2.) [FAS 165, paragraph 5]

Financing Activities

Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; receiving restricted resources that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit. [FAS 095, paragraph 18]

Fund

Used as a verb, to pay over to a funding agency (as to fund future pension benefits or to fund pension cost). Used as a noun, assets accumulated in the hands of a funding agency for the purpose of meeting pension benefits when they become due. [FAS 087, paragraph 264]

Glossary Terms

Gain or Loss

A change in the value of either the projected benefit obligation or the plan assets resulting from experience different from that assumed or from a change in an actuarial assumption. Gains and losses that are not recognized in net periodic pension cost when they arise are recognized in other comprehensive income. Those gains or losses are subsequently recognized as a component of net periodic pension cost based on the amortization provisions of Subtopic 715-30. [FAS 087, paragraph 264]

Goodwill

The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. The amount recognized as goodwill includes acquired intangible assets that do not meet the criteria in Topic 805 for recognition as an asset apart from goodwill.

Note: The following definition is Pending Content; see Transition Guidance in 805-10-65-1. An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized. FAS 164, paragraph 3(n)] [For ease of reference, this term also includes the immediate charge recognized by not-for-profit entities in accordance with paragraph 958-805-25-29. [FAS 164, paragraph 22 FN3]

Impairment

Impairment is the condition that exists when the carrying amount of a long-lived asset (asset group) exceeds its fair value. [FAS 144, paragraph 7]

Intangible Assets

Assets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill.) [FAS 142, paragraph F1]

Legal Entity

Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts. [FIN 46(R), paragraph 3]

Management

Persons who are responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy making functions. Persons without formal titles also may be members of management. [FAS 057, paragraph 24]

Modification

A change in any of the terms or conditions of a share-based payment award. [FAS 123(R), paragraph E1]

Multiemployer Plan

A pension or postretirement benefit plan to which two or more unrelated employers contribute, usually pursuant to one or more collective-bargaining agreements. A characteristic of multiemployer plans is that assets contributed by one participating employer may be used to provide benefits to employees of other participating employers since assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer. A multiemployer plan is usually administered by a board of trustees composed of management and labor representatives and may also be referred to as a joint trust or union plan. Generally, many employers participate in a multiemployer plan, and an employer may participate in more than one plan. The employers participating in multiemployer plans usually have a common industry bond, but for some plans the employers are in different industries and the labor union may be their only common bond. [FAS 106, paragraph 518] Some multiemployer plans do not involve a union. For example, local chapters of a not-for-profit entity (NFP) may participate in a plan established by the related national organization. [FAS 106, paragraph 80]

Operating Activities

Operating activities include all transactions and other events that are not defined as investing or financing activities (see paragraphs 230-10-45-12 through 45-15). Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income. [FAS 095, paragraph 21]

Operating Segment

A component of a public entity. See Section 280-10-50 for additional guidance on the definition of an operating segment. [FAS 131, paragraph 10]

Glossary Terms

Option

Unless otherwise stated, a call option that gives the holder the right to purchase shares of common stock from the reporting entity in accordance with an agreement upon payment of a specified amount. Options include, but are not limited to, options granted to employees and stock purchase agreements entered into with employees. Options are considered securities. See Call Option. [FAS 128, paragraph 171]

Participant

Any employee or former employee, or any member or former member of a trade or other employee association, or the beneficiaries of those individuals, for whom there are pension plan benefits. [FAS 087, paragraph 264]

Plan Assets

Assets—usually stocks, bonds, and other investments—that have been segregated and restricted, usually in a trust, to provide for pension benefits. The amount of plan assets includes amounts contributed by the employer, and by employees for a contributory plan, and amounts earned from investing the contributions, less benefits paid. Plan assets ordinarily cannot be withdrawn by the employer except under certain circumstances when a plan has assets in excess of obligations and the employer has taken certain steps to satisfy existing obligations. Assets not segregated in a trust or otherwise effectively restricted so that they cannot be used by the employer for other purposes are not plan assets even though it may be intended that such assets be used to provide pensions. [FAS 087, paragraph 19] If a plan has liabilities other than for benefits, those nonbenefit obligations may be considered as reductions of plan assets. [FAS 087, paragraph 264] Amounts accrued by the employer but not yet paid to the plan are not plan assets. [FAS 087, paragraph 19] Securities of the employer held by the plan are includable in plan assets provided they are transferable. [FAS 087, paragraph 19]

Prior Service Cost

The cost of retroactive benefits granted in a plan amendment. Retroactive benefits are benefits granted in a plan amendment (or initiation) that are attributed by the pension benefit formula to employee services rendered in periods before the amendment. [FAS 087, paragraph 264]

Probable

The future event or events are likely to occur. [FAS 005, paragraph 3]

Public Entity

Any entity that meets any of the following conditions:

a. Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.

b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

c. It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.

d. It is required to file or furnish financial statements with the SEC.

e. It is controlled by an entity covered by criteria (a) through (d).

Related Parties

Related parties include:

a. Affiliates of the entity.

b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825–10–15, to be accounted for by the equity method by the investing entity.

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management.

d. Principal owners of the entity and members of their immediate.

e. Management of the entity and members of their immediate families.

f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.

Glossary Terms

g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests. [FAS 057, paragraph 24]

Reporting Unit

The level of reporting at which goodwill is tested for impairment. A reporting unit is an operating segment or one level below an operating segment (also known as a component). [FAS 142, paragraph F1]

Restructuring

A program that is planned and controlled by management, and materially changes either the scope of a business undertaken by an entity, or the manner in which that business is conducted, as defined by the International Accounting Standard No. 37 in 2002. [FAS 146, paragraph 2]

Securities and Exchange Commission (SEC) Filer

An entity that is required to file or furnish its financial statements with either of the following:

a. The Securities and Exchange Commission (SEC)

b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.

Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition. [ASU 2010–09, paragraph 3]

Securities and Exchange Commission Registrant

Note: The following definition is Pending Content; see Transition Guidance in 480-10-65-1. An entity (or an entity that is controlled by an entity) that meets any of the following criteria:

a. It has issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

b. It is required to file financial statements with the Securities and Exchange Commission (SEC).

c. It provides financial statements for the purpose of issuing any class of securities in a public market. [FSP FAS150-3, paragraph 3 FN1]

Security

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.

b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.

c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations. [FAS 115, paragraph 137]

Share-Based Payment Arrangements

An arrangement under which either of the following conditions is met:

a. One or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments.

b. The entity incurs liabilities to suppliers that meet either of the following conditions:

    1. The amounts are based, at least in part, on the price of the entity's shares or other equity instruments. (The phrase at least in part is used because an award may be indexed to both the price of the entity's shares and something other than either the price of the entity's shares or a market, performance, or service condition.)

    2. The awards require or may require settlement by issuance of the entity's shares.

The term shares includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. Equity shares refers only to shares that are accounted for as equity. Also called share-based compensation arrangements. [FAS 123(R), paragraph E1]

Glossary Terms

Sponsor

In the case of a pension plan established or maintained by a single employer, the employer; in the case of a plan established or maintained by an employee entity, the employee entity; in the case of a plan established or maintained jointly by two or more employers or by one or more employers and one or more employee entities, the association, committee, joint board of trustees, or other group of representatives of the parties that have established or that maintain the pension plan. [FAS 087, paragraph 264]

Subsequent Events

Events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued. There are two types of subsequent events:

a. The first type consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements (that is, recognized subsequent events).

b. The second type consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date (that is, nonrecognized subsequent events). [FAS 165, paragraph 4]

Subsidiary

An entity that is controlled, directly or indirectly, by another entity.

Note: The following definition is Pending Content; see Transition Guidance in 810-10-65-1. An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.) [ARB 51, paragraph B1]

Vest

To earn the rights to. A share-based payment award becomes vested at the date that the employee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions.

The stated vesting provisions of an award often establish the requisite service period, and an award that has reached the end of the requisite service period is vested. However, as indicated in the definition of requisite service period, the stated vesting period may differ from the requisite service period in certain circumstances. Thus, the more precise (but cumbersome) terms would be options, shares, or awards for which the requisite service has been rendered and end of the requisite service period. [FAS 123(R), paragraph E1]

Volatility

A measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Volatility also may be defined as a probability-weighted measure of the dispersion of returns about the mean. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period. That is the same as the standard deviation of the differences in the natural logarithms of the stock prices plus dividends, if any, over the period. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Volatility is typically expressed in annualized terms. [FAS 123(R), paragraph E1]

Weighted-Average Number of Common Shares Outstanding

The number of shares determined by relating the portion of time within a reporting period that common shares have been outstanding to the total time in that period. In computing diluted EPS, equivalent common shares are considered for all dilutive potential common shares. [FAS 128, paragraph 171]