



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

2018

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# Preface

March 2018

To the clients, friends, and people of Deloitte:

We are pleased to present the 2018 edition of *A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions*.

“Carve-out financial statements” is a general term used to describe financial statements derived from the financial statements of a larger parent entity. Carve-out transactions might occur when a parent entity wishes to pursue a sale, spin-off, or initial public offering (IPO) of a portion of the parent entity. Carve-out financial statements are needed to complete a carve-out transaction and reflect the portion of a parent entity’s balances and activities that are the subject of the transaction. 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 entities often refer 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 carve-out financial statements.

To help streamline the preparation of carve-out financial statements, this publication summarizes key factors to consider. Such considerations are presented in the following chapters:

- ***Chapter 1, “Key Concepts Related to Carve-Out Financial Statements”*** — This chapter identifies 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. In addition, it highlights some practical considerations that management should take into account when preparing carve-out financial statements.
- ***Chapter 2, “Accounting Considerations Related to a Carve-Out Entity’s Statement of Financial Position”*** — This chapter discusses accounting and disclosure guidance on common balance sheet items included in carve-out financial statements.
- ***Chapter 3, “Accounting Considerations Related to a Carve-Out Entity’s Statement of Comprehensive Income”*** — This chapter discusses accounting and disclosure guidance on common income statement items included in carve-out financial statements.
- ***Chapter 4, “Other Accounting and Financial Reporting Items”*** — This chapter expands on the items introduced in Chapters 2 and 3 by discussing additional accounting and financial reporting guidance on topics such as statement of cash flows, discontinued operations, and subsequent events.
- ***Chapter 5, “SEC Reporting Topics”*** — This chapter identifies the various SEC reporting topics that carve-out entities and the parent entity need to consider when preparing IPO and other SEC filings.

In addition, this publication contains the following appendixes:

- *Appendix A* — Template for request to SEC to provide statements of assets acquired and liabilities assumed and revenues and direct expenses.
- *Appendix B* — Titles of standards and other literature.
- *Appendix C* — Abbreviations.

Subscribers to the [Deloitte Accounting Research Tool \(DART\)](#) may access any interim updates to this publication by selecting the document from the “Roadmaps” tab on DART’s home page. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

We encourage you to use this publication as you prepare carve-out financial statements. This Roadmap is intended to be a helpful resource; however, it is not a substitute for consulting with professional advisers on complex accounting questions and transactions. We hope that we will be able to serve you as you complete your carve-out transactions.

Sincerely,

Deloitte & Touche LLP

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# Introduction

Carve-out financial statements are prepared to reflect a portion of a parent entity's balances and activities. Examples of carve-out transactions in which carve-out financial statements may be requested or required include, but are not limited to, the following:

- *Potential sale* — An entity wishing to dispose of a portion of its assets and operations may prepare carve-out financial statements to help potential acquirers evaluate a prospective transaction.
- *Completed sale* — A public entity acquires, or it is probable that the public entity will acquire, a portion of an entity's business, and the acquisition is deemed "significant" to the acquirer under SEC Regulation S-X, Rule 3-05. Consequently, the acquiring entity may request audited carve-out financial statements of the business acquired for inclusion in a Form 8-K filing, a registration statement, or a proxy statement of the acquirer.
- *Spin-off* — A public entity plans to distribute a portion of its assets that constitute a business by spinning the business off to its shareholders as a separate public company with the carve-out financial statements of the spinnee included in the SEC registration statement in connection with the public registration of the shares of the spinnee before the spin-off.
- *IPO* — An entity wishes to segregate a portion of itself to effect an IPO of a newly created subsidiary. Therefore, carve-out financial statements of the operations to be segregated and transferred to the newly created subsidiary must be included in the SEC registration statement in connection with the IPO.

There are numerous types of transactions that precipitate the need for carve-out financial statements. The nature of the transaction will affect both the needs or requirements of financial statement users and the applicability of regulatory requirements. In addition, the nature and significance of the transaction may affect the form and content of the carve-out financial statements (including the number of historical periods that need to be presented in the financial statements) and the identification of the carve-out entity's operations.

# Chapter 1 — Key Concepts Related to Carve-Out Financial Statements

## 1.1 Identifying the Form and Content of the Carve-Out Financial Statements and the Operations of the Carve-Out Entity

### 1.1.1 Form and Content of the Carve-Out Financial Statements

The form and content of the carve-out financial statements depend on the needs or requirements of the users of the financial statements and any regulatory requirements applicable to the transaction for which the carve-out financial statements are being prepared.

Accordingly, the following carve-out financial statements may be prepared:

- *Public entity financial statements* — When carve-out financial statements are required for a registrant and its predecessor<sup>1</sup> in an initial registration statement filed with the SEC as well as in Forms 10-K and 10-Q filed after the initial registration statement, such financial statements must comply with the general financial statement requirements in SEC Regulation S-X, Rules 3-01 through 3-04. Such carve-out financial statements may also be used for a significant acquired or to be acquired business in accordance with SEC Regulation S-X, Rule 3-05, in certain SEC filings. See [Sections 5.1](#) and [5.2](#) for additional information about the financial statement requirements applicable to a registrant and its predecessor and financial statements of businesses acquired or to be acquired in an SEC filing.

Abbreviated financial information may be provided for significant acquired or to be acquired businesses in accordance with SEC Regulation S-X, Rule 3-05, in certain SEC filings. These abbreviated financial statements typically consist of a statement of revenues and direct expenses (in lieu of a full statement of operations) and a statement of assets acquired and liabilities assumed (in lieu of a full balance sheet). Abbreviated income statements for acquired or to be acquired real estate operations in accordance with SEC Regulation S-X, Rule 3-14, may also be provided. See [Sections 5.2.4](#) and [5.3](#) for more information about when abbreviated financial information may be appropriate.

- *Nonpublic entity financial statements* — Certain U.S. GAAP presentation and disclosure requirements are not applicable to nonpublic entities. In addition, nonpublic entities may elect to apply reporting alternatives developed by the Private Company Council (PCC) and subsequently endorsed by the FASB. Nonpublic-entity carve-out financial statements in which PCC accounting alternatives have been elected may be appropriate when the financial statements are not included in an SEC filing.<sup>2</sup>

<sup>1</sup> Determining the appropriate predecessor in an SEC filing is important since such determination will affect which financial statements are required to be included in an SEC filing, as well as other considerations. In certain circumstances, there could be more than one predecessor.

<sup>2</sup> For additional information, see [Chapter 5](#).

- *Special-purpose financial information* — A user may ask for financial information in a specific form or for it to be prepared in accordance with another comprehensive basis of accounting. While such information may be prepared to suit the user's request, there will most likely be restrictions on the use of such information as well as the level of attestation available. Further, since the form and content of financial statements to be included in SEC filings are prescribed, the financial information prepared under a special-purpose framework may not be usable for SEC filings.

In addition, preparers of carve-out financial statements should discuss with their auditor the level of assurance that may be provided for the planned form and content. Reissuance of the carve-out financial statements may require the auditor to reissue its opinion(s) or other form of attestation. Changes in the intended users of the carve-out financial statements or in the planned form and content of the financial information of the carve-out entity may change the level of assurance sought or that can be provided. Accordingly, any such changes should be monitored throughout the carve-out transaction process.

### **1.1.2 Basis of Presentation: Identifying the Carve-Out Entity's Assets, Liabilities, and Operations**

The business or activities that are the subject of the carve-out transaction provide the basis for identifying the assets, liabilities, and operations to be included in the carve-out financial statements. Since a carve-out entity is a subset of a larger parent, complexities can be expected related to the preparation of the carve-out entity's (1) balance sheet; (2) statements of operations, comprehensive income, and cash flows; and (3) related financial statement disclosures. This is especially true when the business of the carve-out entity has not been organized separately within the larger parent entity and when there are significant assets, liabilities, and operations shared with other businesses (see [Chapters 2 through 4](#) for related accounting considerations).

Carve-out financial statements should include disclosure about the basis of presentation that gives users the information necessary to understand them (e.g., a description of the business or activities included in the carve-out financial statements; an explanation of how assets, liabilities, and operations of the carve-out entity were identified; and an indication of whether the carve-out financial statements are consolidated, combined, or both).<sup>3</sup>

When a carve-out entity includes one or more legal entities that previously held assets, liabilities, or operations that are not the subject of the carve-out transaction, management must determine the basis of presentation for historical periods. One basis of presentation is to prepare the carve-out entity financial statements so they reflect all the assets, liabilities, and operations of each legal entity included. Under this basis of presentation, the carve-out entity will reflect disposals of assets, liabilities, and operations that are part of the historical results of the legal entity as they occur, which may not be until the effective date of the carve-out transaction. Another basis of presentation, which may be more meaningful to users of the carve-out financial statements, would be to include only those assets, liabilities, and operations that are the subject of, and will ultimately be included in, the carve-out transaction as of its effective date. Management should carefully evaluate the terms of each carve-out transaction and the most meaningful presentation for users when determining an appropriate basis of presentation of the carve-out financial statements.

When an entity is contemplating filing carve-out financial statements with the SEC, it may wish, depending on the complexities involved in its determination of the basis of presentation, to discuss

<sup>3</sup> The ASC master glossary defines "consolidated financial statements" as "[t]he financial statements of a consolidated group of entities that include a parent and all its subsidiaries presented as those of a single economic entity" and "combined financial statements" as "[t]he financial statements of a combined group of commonly controlled entities or commonly managed entities presented as those of a single economic entity. The combined group does not include the parent."

the proposed basis of presentation of the carve-out entity's financial statements with the SEC staff before they are finalized and filed. Such discussions may serve to facilitate both the preparation of the carve-out financial statements and any subsequent SEC staff reviews.

### 1.1.3 Reverse Spin-Offs

Identifying the carve-out entity and determining reporting requirements may be further complicated in a spin-off transaction accounted for as a reverse spin-off. In a spin-off transaction, an entity must consider the factors in ASC 505-60-25-8 when identifying the accounting spinor and spinnee, which may differ from the legal spinor and spinnee. At the 2014 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff cautioned that the determination of the accounting spinor and spinnee and the related financial statement presentation and SEC reporting requirements for a reverse spin-off transaction require significant judgment:

[W]hen the spinoff is determined to be a reverse spin under Subtopic 505-60, some registrants have assumed that this conclusion dictates the financial statements that are presented in a registration statement that is filed to effect the spinoff. Specifically, some registrants have concluded that when a transaction is accounted for as a reverse spin, the financial statements of the existing registrant (i.e. — the legal spinor) can be used to satisfy the financial statement requirements of the entity that will be spun off (i.e. — the accounting spinor/legal spinnee). On this point, our colleagues in the Division of Corporation Finance view this as an assessment that is based on the unique facts and circumstances of each transaction, and there may be situations in which carveout financial statements are required for the accounting spinor/legal spinnee in a registration statement relating to a reverse spin. Overall, the separation of an existing registrant into two or more registrants in a spinoff transaction may present a number of reporting questions, both with respect to the registration statement as well as the subsequent Exchange Act reports for each continuing entity. Given the significant judgments involved in determining the accounting spinor as well as the appropriate financial statement presentation, the staff encourages registrants to continue to consult on their accounting and reporting conclusions relating to spinoffs, particularly when the transaction is expected to be accounted for as a reverse spin.

If management has concluded that a spin-off transaction is expected to be accounted for as a reverse spin-off, or if the determination is subject to a high degree of judgment, management should consider (1) consulting with its auditors and other professional advisers and (2) preclearing its conclusions about the accounting and reporting requirements with the SEC staff if the carve-out financial statements are expected to be included in an SEC filing.

### 1.1.4 Common-Control Transactions

In preparing for a carve-out transaction, an entity may engage in common-control transactions to reorganize its internal structure and move net assets among its subsidiaries. In a common-control transaction, the receiving entity recognizes the transferred assets and liabilities at their carrying amounts on the date of transfer. However, the carrying amounts of the assets and liabilities transferred in the parent's consolidated financial statements sometimes differ from those in the transferring entity's separate financial statements (e.g., if the transferring entity has not applied pushdown accounting). ASC 805-50-30-5 states that in such cases, the receiving entity's financial statements must "reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control." An entity should consider this guidance when determining the historical cost basis of the assets and liabilities of a carve-out entity that were received by the carve-out entity in a common-control transaction.

For additional guidance on accounting for and reporting common-control transactions, see Deloitte's [A Roadmap to Common-Control Transactions](#).

## 1.2 Management Considerations

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

### 1.2.1 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 needed 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).

### 1.2.2 Materiality and Evaluating Misstatements

Because the materiality thresholds related to the carve-out financial statements will most likely be lower than those of the consolidated parent entity, management may need to assess accounts and balances of the carve-out entity more closely than it had as part of preparing the financial statements of the parent. Passed misstatements and disclosures previously considered immaterial to the parent's financial statements that are related to the carve-out entity would need to be reconsidered on the basis of materiality thresholds applicable to the carve-out financial statements.

### 1.2.3 Internal Controls

Management should design and implement processes and controls for preparing the carve-out financial statements (e.g., management may need to design, implement, and execute controls related to the appropriate determination and recording of income statement and balance sheet allocations to the carve-out financial statements). 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 preparing the carve-out financial statements.

### 1.2.4 Supporting Documentation

Management should consider the type of documentation necessary to support the assumptions made and results achieved in preparing 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).

Management may choose 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 segment or component for which discrete financial information is readily available, management may be able to readily extract information from its existing accounting records. However, if the carve-out entity includes portions of different segments, further involvement of IT specialists may be required.

## 1.2.5 Working With Auditors

If, as part of the preparation of carve-out financial statements, external auditors need to perform an audit and issue an audit opinion, the auditors will need to understand the process undertaken by management 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.

Topics on which up-front and regular dialogue with auditors may help facilitate an efficient and effective audit of the carve-out financial statements include the following:

- *Identifying the carve-out entity and the carve-out financial statements* — As indicated above, the preparation of carve-out financial statements is often a complex process, and the form and content of the financial statements will depend on several considerations, including the users of the financial statements and the purpose for which the financial statements are being prepared. Integral to the preparation of carve-out financial statements is the identification of the carve-out entity and the assets, liabilities, and operations of the carve-out entity to be included in the historical periods presented. Management is encouraged to engage its auditors during the planning of the carve-out transaction and before the preparation of the carve-out financial statements; such proactive engagement may help management identify issues and complexities earlier.

Understanding the purpose and the form and content of the carve-out financial statements is important because they will determine the nature of the audit and the type of report to be issued. Management's early engagement of its auditors may also help the auditors develop their risk assessment and procedures for the audit of the carve-out financial statements in a timely manner. Under certain circumstances, management may need to prepare carve-out financial statements for only a portion of an entity that is not considered a stand-alone business. This could result in the designation of the carve-out financial statements as special-purpose financial statements, prepared in accordance with a special-purpose framework instead of under U.S. GAAP. Such financial statements may have auditor reporting implications, such as restrictions on the use of the report by third parties. Further, the audit report for carve-out financial statements may include an emphasis-of-a-matter paragraph to, for example, stress that the financial statements (1) were derived from the financial statements and accounting records of the carve-out entity's parent, (2) include expense allocations for certain corporate functions historically provided by the carve-out entity's parent, (3) may not reflect the actual costs that the carve-out entity would have incurred as a separate entity apart from its parent, and (4) include significant transactions with related parties.

- *Materiality and evaluating misstatements* — Even though management will need to consider materiality when evaluating uncorrected misstatements in the carve-out financial statements, the auditor will often need to calculate a separate materiality to assess risk and plan further procedures for the audit of the carve-out financial statements. Materiality influences many of the auditor's decisions about its audit strategy and scope, including the determination of which locations and accounts are within its scope as well as the extent of its testing to be performed. Materiality is based on quantitative as well as qualitative factors, including the needs of the expected users of the financial statements. The materiality thresholds determined for audits of the carve-out financial statements are usually lower than those used for audits of the parent-company financial statements from which the carve-out financial statements are derived, and amounts considered immaterial or not tested by the auditor at the parent-entity level may be considered material to the carve-out entity's operations.

Because the materiality thresholds will most likely be lower, the extent of incremental procedures to be performed by the auditor will increase. An auditor may need to revise the scope of the prior audits on the basis of the revised materiality for the carve-out financial statements and may need to test (1) account balances that were not tested historically or (2) previously tested account balances by using a lower materiality threshold. In addition, management may need to include certain disclosures in carve-out financial statements that were previously immaterial and undisclosed in the parent-entity financial statements. Auditors will need to perform incremental procedures to test the accuracy and completeness of the disclosures included in the carve-out financial statements.

As a result of the auditor's use of a lower materiality threshold, uncorrected misstatements and omitted disclosures previously considered immaterial to the parent's financial statements may be considered material to the carve-out financial statements. Management should evaluate uncorrected misstatements and omitted disclosures identified during the audit of the parent-company financial statements and determine whether those are applicable to the carve-out financial statements in consultation with its auditors.

If, as part of the preparation of the carve-out financial statements, audit misstatements are identified and determined to be applicable to the carve-out business, the auditor may need to consider the implications of those misstatements on prior or current-period audits of the parent entity. The identification of such misstatements may also result in incremental control deficiencies that will need to be evaluated from an audit scope perspective and may, depending on the severity, require communication to management and those charged with governance.

- *Internal control over financial reporting (ICFR)* — The auditor will need to consider and evaluate controls over the preparation and review of carve-out financial statements as well as the business processes relevant to financial reporting for the carve-out entity regardless of whether these are existing controls that are modified for the carve-out entity or newly created ones. If the auditor concludes that such controls are relevant to the audit, the auditor must perform incremental procedures to test the design and implementation, and potentially the operating effectiveness, of these controls. The extent of such procedures will vary depending on the precision and frequency of the existing or new controls. Management and the auditor may have to invest a significant amount of time and effort to evaluate the new or modified controls.

If the carve-out financial statements will be included in a registration statement filed with the SEC, consultation with legal counsel and auditors is strongly advised to determine the reporting requirements of management and the independent auditor on ICFR. While newly public companies do not need to provide management's report on ICFR in an SEC registration statement or in the first Form 10-K filed after the registration statement is declared effective, management is required to evaluate its internal controls quarterly, and key executives will be required to certify that they have maintained effective disclosure controls and procedures. This certification is required as part of the first Form 10-Q filed by the newly public entity. Auditors are not required to audit or issue an opinion on the effectiveness of ICFR during the registration statement process but could be required to do so in future periodic filings with the SEC.

- *Significant management judgments and management estimates* — The preparation of carve-out financial statements will often require management to make significant accounting judgments and estimates related to allocating account balances and activities to the historical carve-out financial statements and determining the appropriate financial statement disclosures to include in the carve-out financial statements. Accounting and disclosure issues that may require significant accounting judgments and estimates include the following:
  - The allocation of goodwill to the carve-out financial statements and the assessment of goodwill for impairment in the historical periods presented in such financial statements (see [Chapter 2](#)).
  - The identification of the carve-out entity's operating and reportable segments and the preparation and presentation of segment disclosures in the historical periods presented in the carve-out financial statements (see [Chapters 2 and 4](#)).
  - The allocation of pension and postretirement expenses, obligations, and plan assets, as well as share-based compensation expense, to carve-out financial statements (see [Chapter 2](#)).
  - The allocation of expenses for shared assets and facilities or corporate functions to carve-out financial statements (see [Chapter 3](#)).
  - The preparation of the income tax provision and the allocation of DTAs and DTLs to carve-out financial statements (see [Chapter 3](#)).
  - The identification of subsequent events applicable to the carve-out entity and the determination of whether the effects of subsequent events need to be recorded and disclosed in the carve-out financial statements (see [Chapter 4](#)).

Management should prepare detailed documentation that supports the judgments and estimates made in the preparation of the carve-out financial statements.

# Chapter 2 — Accounting Considerations Related to a Carve-Out Entity's Statement of Financial Position

Before preparing the carve-out financial statements, management must determine the purpose of such financial statements and what portion of the parent entity's operations, assets, and liabilities should be included in them. Entities will often begin by going through the balance sheet of the parent entity line by line (e.g., cash; accounts receivable; property, plant, and equipment (PP&E)). For balance sheet items that are inherently related to the carve-out entity, such as PP&E, entities can often readily attribute them to the carve-out financial statements. For many of the balances, however, balance sheet items may not be easily identified; for example, when the balance sheet item is a mixture of the portion of the operations to be included in the carve-out transaction and the portion that is not to be included. This section addresses some of the more complex balance sheet items.

## 2.1 Parent-Entity Net Investment in the Carve-Out Entity

In allocating assets and liabilities and items of income and expense to carve-out financial statements, preparers of carve-out financial statements should be cognizant of the possible disconnect between balance sheet and income statement allocations. Income statement allocations to carve-out financial statements should usually reflect all costs of doing business (see [Chapter 3](#) for additional guidance), whereas the balance sheet of a carve-out entity should generally include the assets currently or formerly owned by the carve-out entity and those liabilities for which the carve-out entity was or is legally responsible. Differences between income statement and balance sheet allocations are typically reflected in equity in the carve-out financial statements as part of the parent's net investment in the carve-out entity (as contributions to the carve-out entity or distributions from the carve-out entity) unless an arrangement between the parent and the carve-out entity requires cash settlement (in which case, differences would be reflected as a net payable to, or net receivable from, the parent). See [Sections 3.2](#) and [4.1.1](#) for further discussion of intercompany balances.

## 2.2 Goodwill

If the parent entity has recorded goodwill and if the carve-out entity constitutes a business as defined in ASC 805-10-55, management must use a reasonable approach to determine the amount of goodwill to include in the carve-out financial statements. Because the intent of carve-out financial statements is to segregate balances and transactions within the parent's financial statements that are related to the carve-out entity, when the carve-out entity represents a reporting unit of the parent entity, the goodwill balance of the reporting unit is generally included in the carve-out financial statements.

When only a portion of one or more reporting units of the parent is included in the carve-out entity's financial statements, goodwill of the reporting unit or units is typically assigned to the carve-out entity on the basis of the guidance in ASC 350-20-35-45 and 35-46, which provides for a relative fair value allocation approach consistent with that used by the parent when a portion of a reporting unit is disposed of.

Sometimes a recent acquisition of the parent is included in the carve-out entity but is part of a larger reporting unit of the parent. To avoid underreporting the historical goodwill of the carve-out entity, management may need to consider the goodwill resulting from the recent acquisition when it allocates goodwill to the carve-out entity. In such a case, goodwill amounts resulting from the acquisition might be included in the carve-out financial statements along with the net assets of the acquisition before management performs a relative fair value allocation. Similarly, when a recent acquisition included in a larger reporting unit of the parent will not be included in the carve-out entity, goodwill amounts along with the net assets of the acquisition might be excluded before management performs a relative fair value allocation.

The appropriateness of the specific identification of goodwill of a prior acquisition within a larger reporting unit of the parent and the inclusion of that goodwill in or the exclusion of it from the carve-out financial statements is expected to be affected by the length of time since the prior acquisition occurred given that a more recent acquisition offers less likelihood that the goodwill will have lost its connection to the prior acquisition. The goodwill resulting from a prior acquisition may also have lost its connection to the prior acquisition when the goodwill of the prior acquisition has been included with other goodwill in a reporting unit of the parent that has experienced impairments or has undergone a reorganization.

Note that the amount of goodwill included in the carve-out financial statements might differ from the amount of goodwill the parent entity derecognizes from its financial statements when the parent entity divests of a carve-out entity (see [Section 2.2.4](#)).

We believe that in the absence of specific guidance regarding the allocation of goodwill to a carve-out entity, judgment is necessary related to the goodwill allocation approach used. This judgment, as with judgments related to allocation of certain other assets, liabilities, and expenses, should be evaluated as to whether it is reasonable and supportable under the specific facts and circumstances.

## 2.2.1 Identifying Operating Segments and Reporting Units

The carve-out entity's operating segments may differ from those identified in the parent entity's reporting structure. As defined by ASC 280-10-50-1, an operating segment has the following characteristics:

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

The CODM is the person or function that will be responsible for reviewing the discrete segment financial statement information of the carve-out entity. In addition, the discrete financial statement information for the carve-out entity 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 should 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.

For additional guidance on segment reporting, see Deloitte's *A Roadmap to Segment Reporting*.

## 2.2.2 Goodwill Impairment Testing

When goodwill amounts allocated to the carve-out entity are derived from the goodwill balances of the parent, as discussed in [Section 2.2](#), we believe that the goodwill amounts allocated to the carve-out entity carry with them the results of the parent's previously performed goodwill impairment tests. Accordingly, upon allocation, there is no requirement to perform impairment testing for historical periods in the carve-out financial statements even if different reporting units are identified going forward for the carve-out entity. This approach is consistent with the view that the formation of the carve-out entity is akin to a reorganization of reporting units of the parent entity for which U.S. GAAP does not require retrospective testing of goodwill under the reorganized structure. Future goodwill impairment testing should be performed for the carve-out entity on the basis of its reporting unit structure at the date of each subsequent test.

Because there is no authoritative guidance on impairment testing of goodwill presented in a carve-out entity's historical financial statements, we are aware that some believe that the goodwill included in the carve-out entity should be subjected to testing in each historical period presented, as if the carve-out entity had been a separate subsidiary of the parent in all such historical periods. Entities may find support for this approach in the framework described in ASC 350-20-35-48, which requires them to test the goodwill recognized in a subsidiary's separate financial statements for impairment at the subsidiary level by using the subsidiary's reporting units.

Entities evaluating an approach whereby goodwill included in the carve-out entity is subjected to testing in each historical period presented should consider the potential impracticability of identifying reporting units for prior periods in the carve-out financial statements when a CODM or operating segment and reporting unit structure may not have been in place in those periods. Further, it may be impracticable to develop the necessary business and valuation assumptions for goodwill impairment testing for each presumed reporting unit in each historical period. Moreover, in evaluating this approach, entities should consider whether it suggests an overall framework for the preparation of the carve-out financial statements that is consistent with an initial issuance of financial statements, which may affect how goodwill should be allocated to the carve-out entity (see [Section 2.2](#)) and how subsequent events should be evaluated in the carve-out financial statements (see [Section 4.7](#)).

## 2.2.3 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 350-20]
- 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 disclosed in the parent-entity financial statements for these various components, including the gross amount of goodwill and accumulated impairment losses, as well as the changes in net carrying amount of the carve-out entity's allocated goodwill. This may be challenging if the parent entity 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).

See [Section 4.5](#) for a discussion of disclosure requirements for reportable segments.

## 2.2.4 Additional Parent-Entity Considerations

When the parent entity divests of the carve-out entity, it must determine the amount of goodwill to include with the disposal by using the guidance in ASC 350-20-40-1 through 40-6, which may require a relative fair value allocation. Differences may exist between (1) the allocation method used by the parent entity in determining the amount of goodwill to attribute to the net assets disposed of and (2) the method used to identify and attribute goodwill to the financial statements of the carve-out entity. These differences may result in the parent entity's allocating an amount of goodwill to the financial statements of the carve-out entity that is different from the amount of goodwill the parent entity allocates to the net assets it disposes of. In addition, ASC 350-20-40-7 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.

## 2.3 Other Long-Lived Assets: Impairment Testing

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. Typically, long-lived assets assigned to a carve-out entity that were determined to be recoverable at the parent-entity level remain recoverable when considered at the carve-out level since, under ASC 360, long-lived assets are tested at the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.<sup>1</sup>

If the parent entity has recorded historical impairment charges related to long-lived assets assigned to the carve-out entity (e.g., PP&E), such impairments would be reflected in the carve-out financial statements.

<sup>1</sup> See ASC 360-10-35-23 through 35-25.

## 2.4 Parent-Entity Debt

Before the FASB issued [ASU 2014-17](#), entities preparing carve-out financial statements looked to the guidance in Question 3 of SAB Topic 5.J when considering whether parent-entity debt should be reflected in the carve-out entity's financial statements. This guidance previously required the pushdown of debt incurred by an acquirer to fund the acquisition of an acquiree in the separate financial statements of the acquiree prepared in connection with a debt or equity offering of the acquiree if (1) the acquiree was to assume the debt (currently or in a planned future transaction), (2) the proceeds of the debt or equity offering would be used to retire the acquirer's debt, or (3) the acquiree guaranteed or pledged its assets as collateral for the acquirer's debt. This guidance was nullified by the SEC in response to ASU 2014-17. The ASU added the guidance codified in ASC 805-50-30-12, which indicates that an acquiree should recognize in its separate financial statements an acquisition-related liability incurred by the acquirer only if the liability represents an obligation of the acquiree in accordance with other U.S. GAAP.

In preparing carve-out financial statements, entities should attribute parent-entity debt to the carve-out financial statements only if the parent-entity debt represents an obligation of the carve-out entity in accordance with other U.S. GAAP. For additional general guidance, see ASC 405.

## 2.5 Defined Benefit Plans

In some cases, the carve-out entity's employees 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 typically apply one of two 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 allocations of the plan's benefit obligation, plan assets, and related AOCI balances are included in the carve-out entity's balance sheet. The method chosen should be appropriately disclosed in the carve-out financial statements.

### 2.5.1 Multiemployer Approach

Use of a multiemployer approach is based on analogy 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 financial statements. An intercompany payable or receivable may be included in the carve-out financial statements 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 assumed by the carve-out 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.

## 2.5.2 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 in the carve-out financial statements. This approach may be more helpful to financial statement users if the carve-out entity will assume part of the benefit obligation 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 the carve-out financial statements.

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 included in AOCI is 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 the preparation of the carve-out financial statements should reflect the terms of any such agreement.

## 2.5.3 Other Considerations

The purpose and the timing of the preparation of carve-out financial statements may be relevant to the evaluation of which method of accounting for defined benefit plans is most appropriate in a given set of facts and circumstances. For example, the allocation approach might be considered more appropriate when there already is an agreement in place between a buyer and seller of a business that clearly delineates which part of the parent entity's benefit obligation will be assumed by the buyer. In other situations, historical carve-out financial statements may be prepared in advance of a transaction agreement to assist the parent entity in marketing and selling the carve-out business. In the absence of contractual terms between a buyer and seller that support the structure of the transaction and related treatment of the benefit obligation, the multiemployer approach might be considered more appropriate.

In the case of legal plan separations in the United States, ERISA includes explicit guidance on how the plan assets must be allocated. The ERISA 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, typically through equity, unless an agreement between the entity (or its new owners) and the former parent provides for a different treatment.

## 2.5.4 Parent-Entity Considerations

The parent entity 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 entity 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.

## 2.6 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.

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

## 2.7 Contingencies

If the carve-out entity is the primary obligor for a contingent liability (e.g., legal or environmental) as a result of its operations, the contingent liability should be recognized in the carve-out entity's financial statements. If the parent entity is the primary obligor, the contingent liability might still be recognized in the carve-out entity's financial statements when the liability is related to the carve-out entity's operations and will be assumed by the carve-out entity as a result of the carve-out transaction.

Notwithstanding the inclusion of the liability, the historical carve-out financial statements should reflect all the carve-out entity's costs of doing business, including costs incurred on the carve-out entity's behalf by its parent (see [Chapter 3](#) for additional guidance). Therefore, circumstances may occur in which the expenses related to a contingent liability are recorded in the carve-out entity's income statement while the related liability is not. See [Section 2.1](#) for discussion of the reporting of differences between income statement and balance sheet allocations.

When evaluating the disclosure requirements in ASC 450-20-50, management must take into account the fact that contingencies previously considered immaterial to the parent's financial statements that are related to the carve-out entity may require disclosure on the basis of materiality thresholds applicable to the carve-out financial statements (see [Section 1.2.2](#)).

## 2.8 Other Assets and Liabilities

For assets and liabilities for which specific guidance does not exist, 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.

[Sections 2.8.1 through 2.8.3](#) provide examples of such items as well as considerations related to developing an appropriate allocation method.

### 2.8.1 Working Capital

Companies often have centralized cash management functions involving “sweep” accounts. In addition, many companies have centralized cash collection and bill payment shared services centers. When shared services centers are used and the customers and vendors of the carve-out entity overlap with those of its parent, it can be challenging to identify receivables and payables related to the carve-out entity (see [Sections 3.2](#) and [4.1.1](#) for further discussion). In these situations, management may need to modify systems to identify working capital items that are attributable to the carve-out entity.

### 2.8.2 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. Management should consider where the employee provided services within the consolidated entity as well as where the employee will be employed once the carve-out transaction is completed. Often, these factors align (e.g., when the carve-out entity represents a reportable segment of the parent, and the employee for that reportable segment will transfer with the carve-out entity). Careful consideration is necessary to ensure that costs are properly reflected in the carve-out financial statements in situations in which the employee provided services to the carve-out entity but will not transfer with it.

### 2.8.3 Self-Insurance Accruals

Self-insurance accrual allocations can be complex and generally require the involvement of an actuary. If the parent entity maintains sufficient claim detail, management may be able to identify the specific claims attributable to the carve-out entity. For example, if a parent entity 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 entity 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 head count associated with the carve-out entity.

If management has previously allocated self-insurance expense and liabilities to the carve-out entity, it should apply consistent allocation methods when it prepares the carve-out financial statements.

# Chapter 3 — 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 to determine the carve-out entity's revenue and expenses. Because revenue is typically what defines a business, it often is not difficult to attribute revenues to the carve-out entity's financial statements. Complexities may arise, however, when historical intercompany revenues or related-party transactions exist, and in management's determination of the appropriate allocation of certain expenses to the carve-out entity.

## 3.1 Expenses Clearly Applicable

The identification and allocation of expenses directly related to the carve-out entity's revenue-producing activities (e.g., cost of goods sold) may be straightforward and readily available from the entity's historical records through specific identification with the related revenues.

Because there is limited authoritative guidance issued by the FASB on the allocation of other expenses not directly related to the carve-out entity's revenue-producing activities in the carve-out financial statements, entities typically apply the SEC guidance in [SAB Topic 1.B.1](#) (codified in ASC 220-10-S99-3) directly or by analogy when performing such allocations. Questions 1 and 2 of SAB Topic 1.B.1 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.

Question 1 of SAB Topic 1.B.1 indicates that a subsidiary's historical financial statements "should reflect all of its costs of doing business," including costs incurred on the subsidiary's behalf by its parent. For those costs incurred on the subsidiary's behalf by its parent, Question 2 of SAB Topic 1.B.1 states that "any expenses clearly applicable to the subsidiary [should] be reflected in its income statements." The SEC staff did not provide any further guidance on the determination of which expenses are "clearly applicable" to a subsidiary, and such a determination requires judgment.

For expenses that are "clearly applicable" but for which specific identification is not practicable, management should develop a reasonable allocation method that can be used to allocate the expenses to the carve-out entity. Methods used historically, such as a recurring management fee, are typically not adjusted in the preparation of carve-out financial statements.

Different allocation methods may be determined to be reasonable on the basis of different types of common expenses. For example, head count may be viewed as a reasonable basis of allocation for certain employee costs, while square footage may be viewed as a reasonable basis of allocation for certain occupancy costs.

Historical costs included in the carve-out entity may not be an accurate indicator of the future costs of the carve-out entity. However, any attempt to adjust historical costs in the carve-out entity to reflect future estimated costs is inappropriate.

## 3.2 Intercompany Transactions

Because the intent of carve-out financial statements is to isolate transactions related to the entity 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 within the carve-out entity).

To properly account for intercompany balances, an entity must determine when the intercompany payables and receivables will be settled (either before or after the transaction) and by what means (e.g., cash payment or via an equity transaction). For example, it is not uncommon for a parent entity to forgive certain intercompany balances (such as certain intercompany payables); such balances would therefore not result in cash settlement. Consequently, such forgiven amounts would be accounted for as equity contributions in the carve-out financial statements. Conversely, balances that are expected to be settled in cash would be reflected as "due to or from" the parent entity in the carve-out financial statements.

### 3.2.1 Internal Control Over Intercompany Balances and Activities

To the extent that there are intercompany transactions between the carve-out entity and parent, management should consider whether the controls in place are sufficiently precise to cover the transactions at an intercompany level. For example, if management uses certain transaction codes to identify intercompany sales, it should consider whether there are controls over the master data inputs and changes to the transaction code field that would ensure that the identification of intercompany amounts is complete and accurate. Further emphasis should be placed on whether the transactions are appropriately reflected within and among the appropriate entities so that management can evaluate whether the transactions are completely and accurately stated in the carve-out financial statements. 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 parent's system (since such amounts were most likely eliminated during consolidation).

### 3.3 Allocation of Cash-Based Compensation Expense

Management should consider its historical overhead allocations of cash-based compensation expense. Management's allocation of cash-based compensation expense might take into account (1) the carve-out entity's head count as a percentage of total head count, (2) the percentage of employees' time spent working on the business of the carve-out entity, and (3) the carve-out entity's sales (or earnings) as a percentage of total sales (or earnings). If the company had previously allocated a portion of overall compensation expense to the carve-out entity for previously prepared financial statements, a consistent portion of compensation should also be allocated to the carve-out financial statements.

### 3.4 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 attributable to a stock compensation plan of the carve-out entity 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.

Since stock compensation information is available at the individual-employee level, the determination of the related expense to be included in the carve-out entity is generally straightforward unless the expense is related to employees who spend only a portion of their time on the carve-out entity's business. In such cases, a reasonable and supportable allocation method should be used (see [Section 3.1](#) for further discussion). Management's method of allocation of share-based compensation expense is typically the same as its method of allocation of cash-based compensation expense, as described in [Section 3.3](#).

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 will include in its financial statements the parent's consolidated stock compensation disclosures, along with the disclosure of the allocation method.

For information about the accounting for share-based compensation awards (including accounting for modifications to awards), see Deloitte's *A Roadmap to Accounting for Share-Based Payment Awards* (2017). While [ASUs 2016-09](#) and [2017-09](#) are not yet effective for all companies, the guidance in the 2017 edition is written as if adoption has occurred. For a discussion of the guidance on share-based payment awards before the adoption of ASUs 2016-09 and 2017-09, see Deloitte's [2015 edition](#).

### **3.4.1 Modifications to Awards**

In contemplation of a carve-out transaction, management may choose to modify stock compensation awards. In addition, such awards may have a provision in which their vesting is accelerated because of the carve-out transaction's completion. Management should consider how much of (1) the incremental compensation costs from a modification and (2) the costs associated with the acceleration of vesting (if any) should be allocated to the carve-out entity.

#### **3.4.1.1 Incremental Compensation Costs From a Modification**

ASC 718-10-20 defines a modification as a "change in the terms or conditions of a share-based payment award." A modification under ASC 718 is viewed as an exchange of the original award for a new award, typically one with equal or greater value. Any incremental value of the new (or modified) award usually is recorded as additional compensation cost on the modification date (for vested awards) or over the remaining service (vesting) period (for unvested awards). The incremental value (i.e., incremental compensation cost) is computed as the excess of the fair-value-based measure of the modified award on the modification date over the fair-value-based measure of the original award immediately before the modification.

In addition to considering whether a modification results in incremental compensation cost that must be recognized, an entity must determine whether it should recognize the award's original grant-date fair-value-based measure. Generally, total recognized compensation cost attributable to an award that has been modified is at least the grant-date fair-value-based measure of the original award unless the original award is not expected to vest under its original terms (i.e., either the service condition or the performance condition or neither is expected to be achieved). Therefore, total recognized compensation cost attributable to an award that has been modified is typically the sum of (1) the grant-date fair-value-based measure of the original award for which the required service has been provided (i.e., the number of awards that have been earned) or is expected to be provided and (2) the incremental compensation cost conveyed to the holder of the award as a result of the modification. However, if the original award is not expected to vest under its original terms, any compensation cost recognized is based on the modification-date fair-value-based measure of the modified award (i.e., the grant-date fair-value-based measure of the original award is disregarded).

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 an equity restructuring. If an entity does not contemplate an equity restructuring when it adds an antidilution provision, the

addition would not typically result in a modification so long as there are no other changes to the award; as a result, no incremental compensation cost would be recorded. In determining whether an adjustment is required in the event of an equity restructuring (i.e., whether the antidilution provision is nondiscretionary or discretionary), an entity should carefully review the terms of its awards and may need to obtain the opinion of legal counsel.

### **3.4.1.2 Costs Associated With the Acceleration of Vesting**

Vesting for share-based payment awards may be accelerated in connection with a carve-out (e.g., through either a modification or a preexisting change-in-control provision). Questions have arisen regarding whether any of the costs associated with the acceleration of vesting (including accelerated recognition of previously unrecognized compensation costs as well as incremental compensation costs, if any, recorded as a result of modification accounting) should be allocated to the carve-out financial statements. The answer to such questions usually depends on whether the costs are viewed as more akin to a parent entity's selling costs or to ongoing costs of the carve-out entity's business. If the former, the costs would generally not need to be allocated to the carve-out entity. Management will need to exercise significant judgment in making that determination.

Many modifications are made before a transaction (e.g., an IPO) date but are not effective unless the transaction occurs. While the date the contingent modification is made is generally the modification date used in the measurement of compensation cost, the accounting consequence may not be recognized until the transaction's effective date if the modification is contingent on the transaction's occurrence. For example, an award could be modified to increase the quantity of underlying shares upon a successful IPO. In such a circumstance, any additional compensation cost (as determined on the modification date) would not be recognized until the IPO is effective since IPOs are typically not considered probable until they occur.

## **3.5 Income Taxes**

It is critical for an entity to assess and understand the legal structure of the operations to be included in carve-out financial statements because it will be a primary factor for determining whether and, if so, how income taxes are accounted for in those financial statements.

ASC 740-10-30-27 requires a group of entities that files a consolidated tax return to allocate the "consolidated amount of current and deferred tax expense . . . among the members of the group when those members issue separate financial statements." For income tax accounting purposes, a "member" is generally a taxable legal entity (i.e., a corporation or an LLC that has elected to be taxed as a corporation) that is included in the parent's consolidated tax return. Thus, if the carve-out entity comprises one or more taxable legal entities that are included in the parent's consolidated tax return (as might be the case if the carve-out financial statements are being prepared in connection with a spin-off of a subsidiary), an allocation of current and deferred income tax expense is explicitly required under ASC 740-10-30-27.<sup>1</sup>

<sup>1</sup> An allocation of current and deferred taxes would also be required by SAB Topic 1.B.1 for the carve-out financial statements of certain nonmembers (i.e., divisions and lesser components of another entity) if such financial statements are to be filed with the SEC. See Deloitte's [A Roadmap to Accounting for Income Taxes](#) for additional guidance.

ASC 740-10-30-27 does not prescribe a particular method for allocating current and deferred income taxes in the income statement of separate financial statements of a member; rather, it requires only the use of a systematic and rational method that is consistent with the broad principles established by ASC 740. Several income tax allocation methods may meet the requirements of ASC 740-10-30-27, including the commonly applied separate-return and parent-entity-down methods. Question 3 of [SAB Topic 1.B.1](#) states that for public entities, the separate-return approach is preferable to other approaches and that, if an approach other than the separate-return approach is used, a pro forma income statement that reflects a tax provision prepared under the separate-return method must be provided. For this reason, entities often use the separate-return method to allocate income taxes in carve-out financial statements that will be included in an SEC filing.

See Deloitte's [A Roadmap to Accounting for Income Taxes](#) for additional guidance on the allocation of income taxes in carve-out financial statements.

### 3.6 Exit or Disposal Costs

In preparing for a carve-out transaction, the parent entity may restructure portions of its business, thereby incurring exit or disposal costs. These costs should be analyzed for allocation to the carve-out entity in accordance with the guidance in [Section 3.1](#). In addition, the parent entity may have incurred exit or disposal costs in historical periods. In preparing carve-out financial statements, the parent entity will have to make determinations about the balance sheet effects, if any, of its prior restructuring activities. See [Section 2.8](#) for considerations related to the identification of the carve-out entity's liabilities.

### 3.7 Transaction-Related Costs

Entities may incur certain transaction costs in connection with a carve-out transaction, such as accounting and tax fees, legal fees, investment banking fees, and employee benefit costs. These transaction-related costs should be analyzed for timing of recognition and allocation to carve-out entities in accordance with the guidance in [Section 3.1](#). If they are contingent on the closing of the carve-out transaction, entities may apply the guidance in ASC 420 and ASC 805-20-55-50 and 55-51 by analogy. In accordance with this guidance, the costs should not be recorded until closing because of the uncertainties involved (in a manner consistent with the accounting for costs associated with the acceleration of vesting of share-based payment awards as described in [Section 3.4.1.2](#)).

Entities may sometimes give bonuses to employees for the successful divestiture of a carve-out entity. If these employees do not work for the carve-out entity, such transaction bonuses should not be allocated to the carve-out entity.

### 3.8 Post-Carve-Out Transaction Agreements

Carve-out entities often enter into various post-transaction-related agreements with the former parent entity (e.g., tax-sharing agreements or transition-services agreements). After separation, these agreements may have a considerable impact on the carve-out entity's financial results. The terms of any such agreements should be evaluated to determine whether substance differs from form (e.g., the substance of a transition services agreement may be a distribution to the former parent as opposed to payments for transition services rendered).

# Chapter 4 — Other Accounting and Financial Reporting Items

## 4.1 Statement of Cash Flows

In developing a statement of cash flows to be presented in carve-out financial statements, management must use judgment and make 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., additions, disposals, and depreciation expense). These amounts should be derived from the parent entity's historical financial statements and would generally not be adjusted for information identified after the issuance of the parent-entity financial statements unless the adjustment is required by U.S. GAAP or other regulatory guidance (see [Section 4.7](#) for further discussion).

### 4.1.1 Intercompany Transactions

The carve-out entity's statement of cash flows typically will be similar to that of the parent entity. However, differences may arise as a result of the presentation of the cash flow effects of intercompany transactions. As discussed in [Section 3.2](#), although intercompany transactions are eliminated in consolidation of the parent entity's financial statements, they generally should not be eliminated from the carve-out financial statements unless they take place within the carve-out entity. Management must evaluate which intercompany transactions, if any, should be reflected in the carve-out entity's financial statements, including the statement of cash flows, by considering intercompany agreements and the nature of the balances. This evaluation may prove challenging when the carve-out entity comprises multiple portions of the parent entity's various affiliates or subsidiaries.

Once management determines the intercompany activity that should be reflected in the carve-out entity's statement of cash flows, it must classify cash receipts and cash payments related to each activity as operating, investing, or financing on the basis of the nature of that activity in accordance with the guidance in ASC 230.

A parent entity may have arrangements in place in which excess cash across the entity is pooled or swept to one or more centralized cash management accounts. When preparing carve-out financial statements of a portion of an entity that uses a centralized cash management arrangement, management must make determinations about the presentation in the carve-out entity's balance sheet of any amounts resulting from participation in the cash pool. Management should also determine how the carve-out entity's deposits to and distributions from the cash pool should be classified in the carve-out entity's statement of cash flows, and it must determine whether such transactions will be presented by the carve-out entity gross or net.

When a carve-out entity determines that presenting amounts due from or due to its parent that result from a cash pool arrangement as intercompany receivables or payables is appropriate, classification of the transactions in the carve-out entity's statement of cash flows will typically be as investing or financing depending on whether the amount is due from or due to the parent entity. Alternatively, when a carve-out entity determines it is appropriate to report the effects of transactions with the cash pool arrangement within equity as part of the parent's net investment, classification of the transactions in the carve-out entity's statement of cash flows will typically be as financing. For further discussion of statement of cash flow reporting considerations involving centralized cash management arrangements, see Deloitte's [A Roadmap to the Preparation of the Statement of Cash Flows](#).

### 4.1.2 Income Taxes Payable

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. To the extent that taxes payable are settled through equity (i.e., as part of the net parent investment), the carve-out entity would include the addback in the financing section of its cash flow statement as part of the net contribution from/distribution to the parent entity.

## 4.2 Discontinued Operations

### 4.2.1 Discontinued Operations — Carve-Out Entity

When the financial statements of the carve-out entity reflect a disposal of a component of the carve-out entity, management must determine whether it should present the disposal as a discontinued operation in the carve-out financial statements even if the disposal did not qualify for discontinued-operations presentation in the parent entity's consolidated financial statements. Specifically, management would consider the guidance in ASC 205-20-45-1B on reporting a discontinued operation, which states, in part:

A disposal of a component of an entity or a group of components of an entity shall be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results.

Management's determination that a portion of the carve-out entity's operations should be presented in discontinued operations will also affect the carve-out entity's statement of cash flows. See [Section 4.1](#) as well as the interpretive guidance in Deloitte's [A Roadmap to the Preparation of the Statement of Cash Flows](#) for further discussion. For additional guidance on reporting discontinued operations, see the interpretive guidance in Deloitte's [A Roadmap to Reporting Discontinued Operations](#).

### 4.2.2 Discontinued Operations — Parent

The parent entity is required under ASC 205-20 to evaluate whether the effect of a disposal resulting from a carve-out transaction is to be presented as a discontinued operation. Depending on the form of the carve-out transaction, this evaluation may occur when (1) the carve-out entity meets the criteria in ASC 205-20-45-1E to be classified as held for sale, (2) the carve-out entity is disposed of by sale, or (3) the carve-out entity is disposed of other than by sale in accordance with ASC 360-10-45-15 (e.g., by abandonment or in a distribution to owners in a spin-off). If the disposal meets the conditions for the parent entity to report it as a discontinued operation, it would be unlikely that amounts presented as discontinued operations for the disposal in the parent-entity financial statements would equal the operations reflected in the carve-out entity's financial statements (e.g., because of differences between how expenses may have been allocated in the carve-out financial statements and how expenses associated with the discontinued operation are determined).

### 4.3 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 EPS for the periods presented, there are considerations related to EPS after the capital structure is in place (see discussion below). 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.

It is common for existing wholly owned incorporated subsidiaries to be capitalized with a nominal number of shares. At the time additional shares of the subsidiary are sold in an IPO, 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.

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-entity options outstanding in prior periods.

### 4.4 Accounting Policies of the Carve-Out Entity

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

If the carve-out entity is acquired in a business combination, the acquirer may choose to conform the accounting policies of the carve-out entity to its own. Should acquisition accounting result in a new basis of accounting for the carve-out entity, the acquirer's accounting policies would be applied without regard to the carve-out entity's previous accounting policies, and there is no need to assess the preferability of the acquirer's policies. Refer to Deloitte's *A Roadmap to Consolidation — Identifying a Controlling Financial Interest* for more information about adopting accounting policies in connection with a change in control.

If the carve-out entity is acquired in a business combination and pushdown accounting is not applied, the carve-out entity would continue to apply in its stand-alone financial statements the policies it had applied before the acquisition, which may differ from the acquirer's accounting policies. If the carve-out entity wanted to adopt the acquirer's policies in its stand-alone financial statements in the absence of pushdown accounting, such a choice would typically represent a voluntary change in accounting principle under ASC 250-10.

If the carve-out entity is spun off, it would continue to apply the policies it had applied before the spin-off in its stand-alone financial statements. If its management wanted to adopt an accounting policy that differed from one it had applied while part of the former parent entity, such a decision would typically represent a voluntary change in accounting principle under ASC 250-10.

Under ASC 250-10, voluntary changes in accounting principles are permitted only if the new accounting principle is preferable. Changes in accounting principles generally need to be applied retrospectively and disclosed in accordance with ASC 250-10. However, not all changes in accounting policies represent changes in accounting principle. For example, an entity may have a policy of expensing all purchases of fixed assets below a certain threshold. Such a policy represents a convention, not an accounting principle. Determining whether a change in accounting policy is a change in accounting principle involves judgment, and a carve-out entity should carefully consider the facts and circumstances.

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 SEC Regulation S-X, Rule 10-01(b)(6), 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 [the] registrant.”

For additional discussion and interpretations of SEC reporting requirements related to a change in accounting policy, see [SAB Topic 6.G.2.b](#) and [paragraph 4230.2\(c\)](#) in the SEC Division of Corporation Finance’s Financial Reporting Manual (FRM).

## 4.5 Segment Reporting

Under ASC 280, carve-out financial statements for public entities (as defined in ASC 280, subject to the scope exceptions in ASC 280-10-15-3) 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 [Section 2.2.1](#), management must first determine the reporting structure and operating segments of the carve-out entity.<sup>1</sup> 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 the carve-out entity’s operations from the parent’s financial statements, the amounts used to determine the quantitative thresholds (mentioned in ASC 280-10-50-10(b) above) would be based on the carve-out entity.

For additional guidance on segment reporting, see Deloitte’s [A Roadmap to Segment Reporting](#).

<sup>1</sup> The determination of the carve-out entity’s operating segments may be required regardless of whether the carve-out entity is required to include segment disclosures under ASC 280 in its financial statements since this determination affects the identification of the carve-out entity’s reporting units for goodwill impairment testing purposes.

## 4.6 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 the parent entity, for example, or with 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 evaluated for disclosure in accordance with ASC 850 for periods before and after the carve-out transaction. Further, for carve-out financial statements that are filed with the SEC (e.g., financial statements for a registrant and its predecessor and a significant acquiree under SEC Regulation S-X, Rule 3-05), management must consider the additional SEC financial reporting requirements of SEC Regulation S-X, Rule 4-08(k), as well as proxy-related disclosures for a registrant and its predecessor.

## 4.7 Subsequent Events

A carve-out entity's financial statements must include subsequent-event disclosures if applicable. Because the carve-out financial statements are derived from the previously issued parent-entity financial statements, the carve-out financial statement disclosures may simply be a subset of the previously issued parent-entity subsequent-event disclosures. Therefore, management would identify only subsequent events that relate to the carve-out entity and include such disclosures in the carve-out financial statements. However, since carve-out financial statements are most likely subject to lower materiality thresholds for disclosure, previously immaterial subsequent events that may not have been disclosed in the parent-entity financial statements may be material to the carve-out entity and therefore may be subject to disclosure in the carve-out financial statements.

We believe that when management evaluates subsequent events in the carve-out financial statements, it should apply the same subsequent-events cutoff dates used for the previously issued parent-entity financial statements when considering potential "recognized" subsequent events. However, when evaluating potential disclosures in the carve-out financial statements, management should consider subsequent events through the date the financial statements are issued (for SEC filers) or available to be issued. If new events are identified after the issuance of the parent-entity 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 typically would not include recognition of the impact of such events (excluding identified errors). This approach is based on a reissuance framework — the premise that carve-out financial statements represent a reissuance of financial statements for subsequent-events purposes. The reissuance guidance in ASC 855-10-25-4 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.

We believe that under this framework, when management is preparing carve-out financial statements for the first time but their content was included in the consolidated results of a parent entity, it should generally not recognize amounts that are different from those that were previously recognized in the parent-entity financial statements on the basis of information that becomes available after the date the parent-entity financial statements were issued or available to be issued. However, management should determine whether such currently available information represents (1) information that management was aware of and misapplied or (2) information of which management should have been aware. 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 an evaluation.

We understand that, when preparing carve-out financial statements, management of some entities has contemplated a framework under which the issuance of financial statements of the carve-out entity is viewed as the initial issuance of those financial statements. Under this framework, the latest period presented in the carve-out financial statements is evaluated for recognized subsequent events through the date the carve-out financial statements are issued or available to be issued. This approach, by not relying on the same subsequent-events cutoff dates used for the previously issued parent-entity financial statements, may result in the reporting of the accounting impacts of certain events that affect the carve-out entity in a different financial statement reporting period than that of the parent entity. In the event that management contemplates taking this approach, consultation with professional advisers is recommended to ensure that its potential implications to other judgments made and assumptions used in the preparation of the carve-out financial statements are evaluated (e.g., goodwill allocation (see [Section 2.2](#)) and goodwill impairment testing (see [Section 2.2.2](#))).

#### **4.7.1 Disclosure of Date Through Which Subsequent Events Were Evaluated — Non-SEC Filer**

Under ASC 855, SEC filers are defined to include only entities that are required to file financial statements with the SEC (or with another appropriate agency in accordance with Section 12(i) of the Exchange Act). Because an entity that files financial statements in an initial registration statement is not required to file its financial statements with the SEC until the registration statement is declared effective, it does not meet the definition of an SEC filer under ASC 855 and therefore must disclose the date through which management evaluated subsequent events in the financial statements. Similarly, the definition of an SEC filer in ASC 855 does not encompass an entity whose financial statements are included in an SEC registrant's filing. Accordingly, when an SEC registrant's filing includes financial statements of an entity that is not considered an SEC filer under ASC 855 (e.g., financial statements of a significant acquiree under SEC Regulation S-X, Rule 3-05), the non-SEC filer must disclose the date through which subsequent events have been evaluated and whether that date was the date of issuance or the date on which the non-SEC filer's financial statements were available to be issued.

# Chapter 5 — SEC Reporting Topics

As discussed in the [Introduction](#), there are several situations in which carve-out financial statements may be requested (or required) in an SEC filing. Preparation of carve-out financial statements is often complex, and the form and content of those financial statements may vary depending on the requirements of the user(s) or any applicable regulations.

Circumstances in which carve-out financial statements may be requested (or required) to meet the SEC's requirements include the following:<sup>1</sup>

- *Registrant and its predecessor* — Carve-out financial statements that comply with the general financial statement requirements in SEC Regulation S-X, Rules 3-01 through 3-04, are generally required for a registrant and its predecessor in an initial registration statement (e.g., Form 10, Form S-1).<sup>2</sup> In addition, these carve-out financial statements of the registrant and its predecessor would be provided in Forms 10-K and 10-Q after the initial registration statement is declared effective for the required comparative periods.
- *Businesses acquired or to be acquired* — When a registrant acquires, or it is probable that it will acquire, a significant business (acquiree), the registrant may be required to file certain acquiree financial statements in accordance with SEC Regulation S-X, Rule 3-05. These financial statements, which may be in the form of carve-out financial statements or abbreviated financial statements, may be required in a Form 8-K, a registration statement, or a proxy statement.
- *Acquired or to be acquired real estate operations* — When a registrant acquires, or it is probable that it will acquire, significant real estate operations,<sup>3</sup> the registrant may be required to file abbreviated income statements for the acquired or to be acquired real estate operations in accordance with SEC Regulation S-X, Rule 3-14. These abbreviated income statements may be required in a Form 8-K, a registration statement, or a proxy statement.

The sections below discuss the form and content of carve-out financial statements under the various SEC requirements.

<sup>1</sup> Carve-out financial statements may also be provided in a nonpublic offering, such as a private placement in accordance with SEC Regulation D or Rule 144A of the Securities Act. While the requirements discussed in this chapter do not strictly apply to private offerings, it is generally standard practice to comply with these rules as if they were applicable.

<sup>2</sup> As noted in [Section 5.2.4](#), the SEC will consider requests to provide abbreviated financial statements for an acquired business identified as a predecessor of the registrant.

<sup>3</sup> [Paragraph 2305.2](#) of the FRM states that “[f]or purposes of S-X 3-14, the term ‘real estate operations’ refers to properties that generate revenues solely through leasing. Examples include office, apartment and industrial buildings as well as shopping centers and malls.”

## 5.1 Financial Statements for a Registrant and Its Predecessor

Two examples of situations in which carve-out financial statements may be included in an initial registration statement for the registrant and its predecessor would be (1) when a public entity plans to spin off a business or group of businesses to shareholders as a separate public company and (2) when a portion of a company is sold to the public in an initial equity offering. Other, less common, transactions, such as put-together transactions, drop-down transactions, split-offs, and “Up-C” transactions, may result in a similar carve-out presentation for a registrant and its predecessor.

In these circumstances, management must take into account the following form and content and reporting considerations in preparing carve-out financial statements for the registrant and its predecessor in an initial registration statement:

- General financial statement requirements in SEC Regulation S-X, Rules 3-01 through 3-04, must be applied; the number of audited periods will depend on the registrant’s filer category (e.g., Emerging Growth Company (EGC),<sup>4</sup> Non-EGC, Smaller Reporting Company).
- SEC reporting and disclosure requirements such as those set forth in Regulation S-X, Staff Accounting Bulletins, Financial Reporting Releases, and Compliance and Disclosure Interpretations (C&DIs) must be applied.
- Public-entity<sup>5</sup> accounting principles must be applied.
- Reporting alternatives in U.S. GAAP, including those developed by the PCC and subsequently endorsed by the FASB, cannot be applied in carve-out financial statements for the registrant and its predecessor; therefore, the effects of any previously elected private-company alternatives must be eliminated.
- Transition provisions related to the adoption of new accounting pronouncements must be applied in accordance with the public-entity adoption dates; therefore, any previously elected nonpublic-entity adoption dates must be retrospectively changed to those required for a public entity.<sup>6</sup>
- PCAOB standards<sup>7</sup> must be applied by the independent registered public accounting firm in auditing the financial statements included in a registration statement filed with the SEC.
- Unaudited interim financial statements and related footnote disclosures may be required depending on the time that has elapsed between the most recent fiscal year and the filing of the initial registration statement and any subsequent amendments through the date the registration statement is declared effective.

<sup>4</sup> As noted in [Topic 10](#) of the FRM, “Title I of the JOBS Act, which was effective as of April 5, 2012, created a new category of issuers called ‘emerging growth companies, or EGCs’ whose financial reporting and disclosure requirements in certain areas differ from [those of] other categories of issuers.” For example, for as long as an issuer qualifies as an EGC, the issuer is not required to (1) present more than two years of audited financial statements in a Securities Act registration statement for an IPO of its common equity securities, (2) adopt the new or revised accounting pronouncements as of the effective dates for public entities if nonpublic entities have a delayed effective date (see footnote 6), or (3) comply with the requirement to provide an auditor’s report on ICFR under Section 404(b) of the Sarbanes-Oxley Act.

<sup>5</sup> The term “public entity” is generally used to refer to an entity that files its financial statements with the SEC. However, public or nonpublic entities may be variously defined in U.S. GAAP depending on which ASC topic is being applied (e.g., ASC 280 on segment reporting). Some ASC topics may refer to a “public business entity” as defined in [ASU 2013-12](#).

<sup>6</sup> EGCs are not required to adopt the new or revised accounting pronouncements as of the effective dates for public entities if nonpublic entities have a delayed effective date (see footnotes 4 and 5). Note, however, that EGCs are not allowed to use private-company accounting alternatives. Refer to [Section 10230](#) of the FRM.

<sup>7</sup> In certain circumstances, auditors are required to refer to **both** auditing standards generally accepted in the United States (i.e., AICPA standards) and the standards of the PCAOB for audits of financial statements of certain nonissuers, including, but not limited to, (1) entities making confidential submissions of an initial public registration statement under the JOBS Act, (2) entities that voluntarily submit a registration statement to the SEC staff for nonpublic review before the company’s public filing (see discussion below about the SEC’s announcement initially issued on June 29, 2017, and revised on August 17, 2017), and (3) entities filing a Form 10 to effect an initial registration of securities (i.e., a spin-off from a public parent entity).

An initial registration statement, in addition to containing the carve-out financial statements of the registrant and its predecessor, must also meet certain SEC reporting requirements. Under those requirements, it may be necessary to include in the initial registration statement other entities' financial statements and certain nonfinancial information, including, but not limited to, the following:

- *Businesses acquired or to be acquired (SEC Regulation S-X, Rule 3-05)* — When a registrant consummates, or it is probable that a registrant will consummate, a significant business acquisition (acquiree), financial statements for the significant acquiree may be required. See [Section 5.2](#) for more information.
- *Equity method investments (SEC Regulation S-X, Rules 3-09 and 4-08(g))* — 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.
- *Real estate operations (SEC Regulation S-X, Rule 3-14)* — As discussed further in [Section 5.3](#), when a registrant acquires, or it is probable that a registrant will acquire, significant real estate operations, the registrant may be required to file abbreviated income statements for the acquired or to be acquired real estate operations.
- *Guarantees of registered securities (SEC Regulation S-X, Rule 3-10)* — Separate financial statements for each subsidiary issuer or guarantor of debt securities registered or being registered must be provided unless certain criteria are met, in which case it may be acceptable to provide (1) condensed consolidating guarantor financial information in the footnotes to the financial statements or (2) narrative disclosures about each subsidiary issuer or guarantor.
- *Issuers of securities that collateralize registered securities (SEC Regulation S-X, Rule 3-16)* — 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 may be required.
- *Pro forma financial information (SEC Regulation S-X, Article 11)* — When a registrant may have consummated a transaction or may be contemplating a probable transaction, pro forma financial statements or other pro forma information may be required.<sup>8</sup>
- *Financial statement schedules (SEC Regulation S-X, Rule 5-04 and Article 12)* — Certain financial statement schedules (e.g., schedule of valuation and qualifying accounts) may be required.
- *Selected financial data (SEC Regulation S-K, Item 301)* — A non-EGC registrant must present, in columnar form, selected financial data for each of the past five years (or for the life of the registrant and its predecessor, if less).<sup>9</sup> In some cases, it may prove difficult if not impossible to prepare five years of historical financial information on a carve-out basis. In such circumstances, a registrant should contact the SEC's Division of Corporation Finance (the "Division") to discuss whether such information may be omitted without comment or objection from the staff.
- *Selected quarterly financial data (SEC Regulation S-K, Item 302)* — Often, a registrant will voluntarily provide the selected quarterly financial information specified in SEC Regulation S-K, Item 302, in its initial registration statement. While such information is not required in an initial registration statement,<sup>10</sup> it is required in a registrant's first annual report on Form 10-K. It is also required in a registration statement filed after the registrant's IPO (often referred to as a "follow-on" registration statement) but before its first Form 10-K.

<sup>8</sup> For additional SEC interpretive guidance on SEC Regulation S-X, Article 11, refer to [Topic 3](#) of the FRM.

<sup>9</sup> If the entity qualifies as an EGC, it would be required to include only information in the selected financial data table for the same periods in which it provides annual financial statements in the registration statement.

<sup>10</sup> In accordance with SEC Regulation S-K, Item 302, the requirements related to selected quarterly financial data apply to registrants that have securities registered under Section 12(b) or 12(g) of the Exchange Act.

- *Management's Discussion and Analysis (SEC Regulation S-K, Item 303)* — A registrant must include a discussion of the financial condition and results of operations for the periods for which financial statements are presented, as well as a discussion of liquidity and capital resources and critical accounting policies, among other items. Refer to [Topic 9](#) of the FRM for further insight into the preparation of MD&A.

Management's assessment of ICFR (and related auditor attestation, if applicable) under Section 404 of the Sarbanes-Oxley Act of 2002 is not required in the initial registration statement. However, a registrant should consider its readiness to comply with the requirements of Section 404 since such requirements will generally apply to the registrant's second annual report on Form 10-K (EGCs are exempt from the auditor attestation requirements). See [Section 1.2.3](#).

On June 29, 2017, the Division issued an [announcement](#) (the "Announcement") that as of July 10, 2017, the SEC is extending to all companies benefits similar to those that are provided to EGCs under the JOBS Act<sup>11</sup> related to the confidential review of draft registration statements. In accordance with the Announcement as revised on August 17, 2017, any company will be able to voluntarily submit the following draft registration statements to the SEC staff for nonpublic review before the company's public filing of:

- An IPO and initial registration statement under the Securities Act.
- An initial registration statement under Section 12(b) of the Exchange Act for a class of securities (e.g., Form 10).
- A registration statement for Securities Act offerings within one year of an IPO or Exchange Act Section 12(b) registration.

In addition, the Announcement indicates that a company may omit financial information from a draft registration statement for historical periods currently required if the company reasonably believes that it will not be required to include these historical periods at the time of the first public filing of the registration statement. [Questions 101.04](#) and [101.05](#) of the Division's C&DIs related to Securities Act Forms further address the annual and interim financial information that may be omitted from a draft registration statement submitted by EGCs and non-EGCs, respectively.

## 5.2 Financial Statements of Businesses Acquired or to Be Acquired (SEC Regulation S-X, Rule 3-05)

Carve-out financial statements are often used to satisfy the requirements of SEC Regulation S-X, Rule 3-05, under which a registrant must file separate preacquisition historical audited financial statements when the registrant acquires (or it is probable that the registrant will acquire) a business<sup>12</sup> that is significant. The financial statement periods required to be filed (i.e., one, two, or three years of audited financial statements) will be based on the significance level determined after performance of any of the three tests described in SEC Regulation S-X, Rule 1-02(w) (i.e., the asset, income, or investment test).<sup>13</sup> Unaudited financial statements as of and for the appropriate interim periods preceding the acquisition may also be required. In addition, the registrant must provide pro forma financial information in accordance with SEC Regulation S-X, Article 11, to reflect the acquisition.

<sup>11</sup> See Deloitte's August 24, 2017, [Heads Up](#) (originally issued July 11, 2017) for further information.

<sup>12</sup> Separate financial statements of an acquiree are required only if the acquiree meets the definition of a business under SEC Regulation S-X, Rule 11-01(d). The definition of a business for SEC reporting purposes is not the same as the definition for U.S. GAAP accounting purposes.

<sup>13</sup> Refer to [paragraph 2030.1](#) of the FRM for financial statement periods required under SEC Regulation S-X, Rule 3-05.

Sections 5.2.1 through 5.2.5 below discuss the various form and content and reporting considerations when carve-out financial statements are filed to meet the requirements of SEC Regulation S-X, Rule 3-05. For additional SEC interpretive guidance on SEC Regulation S-X, Rule 3-05, refer to [Topic 2](#) of the FRM.

## 5.2.1 Form and Content of Acquiree Carve-Out Financial Statements

While the determination of the financial statement periods to be presented for an acquiree is based on the level of significance, the form and content of the acquiree's carve-out financial statements are generally the same as if the acquiree were a registrant and must meet the relevant requirements of SEC Regulation S-X<sup>14</sup> and U.S. GAAP.<sup>15</sup> Supplemental schedules under SEC Regulation S-X, Articles 5 and 12, are not required.

Certain disclosures required under U.S. GAAP may not be required in the acquiree's carve-out financial statements. For example, [paragraph 2005.1](#) of the FRM states that an "acquired business that is a nonpublic entity,<sup>[16]</sup> as that term is defined in GAAP, need not include disclosures if specifically excluded from the scope of the FASB standard." Examples of such disclosures that are not required include:

- EPS, if the acquiree does not have "publicly held common stock or potential common stock," as stated in ASC 260-10-05-1 and as further defined in ASC 260-10-15-2.
- Segment information, if the acquiree does not meet the definition of a public entity under ASC 280-10-20.
- Certain disclosures identified in ASC 715-20-50-5 about employers' pensions and other postretirement benefits, if the acquiree meets the definition of a nonpublic entity under ASC 715-20-20.

## 5.2.2 Defining the Carve-Out Entity

When a registrant acquires, or it is probable that it will acquire, selected, but not all, parts of an entity, it must consider the guidance in [paragraphs 2065.1](#) and [2065.2](#) of the FRM to define the carve-out entity. If the selected parts of an entity being acquired represent substantially all of the entity, full audited financial statements of the entire entity are usually required. Paragraph 2065.1 of the FRM states that in these circumstances, "full audited financial statements of the entity are presumed to be necessary in order to provide investors with the complete and comprehensive financial history of the acquired business."

In other situations, the selected parts of an acquiree do not represent substantially all of the selling entity. Paragraph 2065.2 of the FRM notes that in these circumstances, "financial statements of the larger entity of which the acquired business was a part may not be informative." Therefore, the audited financial statements should represent only the selected parts of the entity acquired, excluding the operations retained by the seller. However, since there is limited guidance on how to define the carve-out entity in these situations, registrants will need to use judgment on the basis of the specific facts and circumstances. Consultation with professional advisers is therefore encouraged. Refer to [Section 1.1](#) for additional considerations.

<sup>14</sup> Companies are reminded that such requirements include classification of redeemable securities or securities whose redemption is outside the control of the issuer as temporary equity in accordance with (1) SEC Regulation S-X, Rule 5-02(27), and (2) Accounting Series Release 268 (FRR Section 211), *Presentation in Financial Statements of "Redeemable Preferred Stocks."*

<sup>15</sup> If the acquiree is a foreign business or a foreign private issuer, refer to [Topic 6](#) of the FRM.

<sup>16</sup> The term "public entity" is generally used to refer to an entity that files its financial statements with the SEC. However, public or nonpublic entities may be variously defined in U.S. GAAP depending on which ASC topic is being applied (e.g., ASC 280 on segment reporting). Some ASC topics may refer to a "public business entity" as defined in ASU 2013-12.

### 5.2.3 Public Business Entity

The definition of a public business entity (PBE) in [ASU 2013-12](#) includes a business entity that is required by the SEC “to file or furnish financial statements, or [do] file or furnish financial statements (including voluntary filers), with the SEC **(including other entities whose financial statements or financial information are required to be or are included in a filing)**” (emphasis added). Therefore, PBEs include entities whose financial statements or financial information is required, for example, under SEC Regulation S-X, Rule 3-05, 3-09, or 4-08(g).<sup>17</sup>

Under ASU 2013-12, entities that meet the definition of a PBE are not eligible to elect certain accounting and reporting alternatives in U.S. GAAP, including those developed by the PCC and subsequently endorsed by the FASB. Therefore, such private-company accounting alternatives cannot be applied in carve-out financial statements of an acquiree under SEC Regulation S-X, Rule 3-05. Further, the effects of any previously elected private-company accounting alternatives would have to be eliminated in the financial statements that management prepared to comply with SEC Regulation S-X, Rule 3-05.<sup>18</sup>

In addition, certain new accounting standards have different adoption dates for public entities and nonpublic entities. If a new standard defines a public entity as a PBE for purposes of applying the transition requirements of that standard, the historical carve-out financial statements for an acquiree must conform to the public-entity adoption dates when management prepares its financial statements to meet the requirements of SEC Regulation S-X, Rule 3-05. Therefore, an acquiree that does not otherwise meet the definition of a PBE could be required to adopt a new accounting standard earlier than planned. However, specific to the FASB’s new standards on revenue and leases, the SEC staff announced that it would not object to elections by certain<sup>19</sup> PBEs to use the non-PBE effective dates for the sole purpose of adopting these two new standards when management prepares financial statements of these acquirees.<sup>20</sup>

These acquirees should continue to be mindful of other accounting standards that have different adoption dates for public and nonpublic entities given that they may be required to adopt standards earlier than planned. While EGCs are not required to adopt new accounting standards by using the PBE effective dates, this accommodation does not apply to acquiree financial statements under SEC Regulation S-X, Rule 3-05.

### 5.2.4 Abbreviated Financial Statements

There may be situations in which it is not practicable for management to prepare full carve-out financial statements of an acquiree, such as when (1) the acquiree is a small portion or a product line of a much larger business and not a stand-alone entity, (2) distinct and separate accounts necessary to present the full financial statements of the business were not maintained, and (3) separate audited financial statements have never been prepared. In such instances, the SEC staff may allow abbreviated financial information — that is, audited statements of assets acquired and liabilities assumed (in lieu of a full balance sheet) and audited statements of revenues and direct expenses (in lieu of a full statement of operations) — to satisfy the financial statement requirements of SEC Regulation S-X, Rule 3-05.

<sup>17</sup> Refer to paragraph BC12 of ASU 2013-12.

<sup>18</sup> ASU 2013-12 states that an “entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity’s filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.” Accordingly, an acquiree can elect to use private-company accounting alternatives in its stand-alone financial statements that are not included in an SEC filing. However, making such an election would require the acquiree to maintain two sets of accounting records and financial information. See footnote 5.

<sup>19</sup> The SEC staff’s announcement at the July 20, 2017, [meeting](#) of the FASB’s Emerging Issues Task Force makes clear that the ability to use non-PBE effective dates for adopting the new revenue and leases standards is limited to the subset of PBEs “that otherwise would not meet the definition of a public business entity except for a requirement to include or inclusion of its financial statements or financial information in another entity’s filings with the SEC.”

<sup>20</sup> See Deloitte’s July 20, 2017, [Heads Up](#) for further information.

[Section 2065](#) of the FRM provides guidance on abbreviated financial information. The statement of revenues and direct expenses should include **all** direct revenues and direct expenses associated with the assets acquired and liabilities assumed. Typically, the only costs excluded are those not directly involved with the revenue-producing activity. For example, the SEC staff will not object to the exclusion of corporate overhead, interest, and taxes as long as the footnotes to the abbreviated financial statements indicate the basis of the presentation as well as the nature of the omitted expenses and the reasons for the omission. All related costs of sales and other SG&A, distribution, marketing, and R&D costs directly associated with producing revenues must be included. The abbreviated financial statements should also include a reasonable allocation of other expenses incurred by the seller on behalf of the business sold. The footnotes should include (1) management’s assertion that the allocation method used is reasonable, as noted in the interpretive response to Question 2 of SAB Topic 1.B (see [Section 3.1](#)); (2) disclosure of the omitted expenses, if known or reasonably available, on an unaudited basis; (3) an explanation of the impracticability of preparing full financial statements; and (4) a statement that the financial statements are not indicative of the financial condition or results of operations of the acquiree because certain operating expenses have been omitted.

The statement of assets acquired and liabilities assumed is generally presented on the basis of the seller’s historical carrying value. In certain circumstances, as stated in [paragraph 2065.5](#) of the FRM, the Division’s Office of the Chief Accountant (CF-OCA) “will consider a registrant’s request to present a statement of assets acquired and liabilities assumed [that is] prepared on the basis of the allocation of the registrant’s purchase price as of the acquisition date.” When preclearance is required, registrants should consider consulting with their auditors and SEC legal counsel.

Generally, it may not be practicable for a registrant to prepare statements of cash flows when presenting abbreviated financial information in lieu of full financial statements or carve-out financial statements. However, as noted in [paragraph 2065.8](#) of the FRM, information about the business’s operating, investing, and financing cash flows is required in the notes to the financial statements or in unaudited supplemental disclosures.

Except for acquisitions of certain oil and gas properties discussed in [paragraph 2065.11](#) of the FRM, the use of this abbreviated financial information in lieu of full financial statements or carve-out financial statements is not permitted without prior written request to the CF-OCA. The request should include an explanation of the impracticability and should also contain:

- The company’s background.
- The acquiree’s background.
- The nature and timing of the transaction.
- The significance level of the acquisition and the periods to be presented for the acquiree.
- The basis for using abbreviated financial statements. At a minimum, the discussion should include:
  - An explanation of the impracticability of preparing full financial statements.
  - Whether the acquired business was accounted for as a separate legal entity or managed as a stand-alone business.
- A description of the proposed financial statements to be provided and an explanation of the expenses included in or excluded from the abbreviated financial statements.
- A conclusion.

A template, included as [Appendix A](#), has been developed for use in preparing the request. This template is only a guide and should be tailored to a registrant's specific facts and circumstances. As noted above, when preclearance is required, registrants should consider consulting with their auditors and SEC legal counsel.

Historically, abbreviated financial statements were not available for an acquired business identified as a predecessor of a registrant. However, as indicated in the note to [Section 2065](#) of the FRM, the SEC staff will now consider requests to provide abbreviated financial statements for an acquired business identified as a predecessor of the registrant (e.g., when full successor financial statements have been presented in the initial registration statement for some periods). Such requests should be directed to the CF-OCA before filing. For a discussion of carve-out financial statements for a registrant and its predecessor, see [Section 5.1](#).

### 5.2.5 Other Considerations for Carve-Out Financial Statements of an Acquiree

When **audited** financial statements of an acquiree are provided under SEC Regulation S-X, Rule 3-05, the audit must be performed in accordance with U.S. GAAS, but compliance with PCAOB standards is not required.<sup>21</sup> SEC regulations generally do not require registrants to obtain an audit or review of interim financial statements provided under SEC Regulation S-X, Rule 3-05. However, a company's underwriters will often require interim information to be reviewed by its independent auditors for due-diligence or comfort purposes.

### 5.3 Acquired or to Be Acquired Real Estate Operations

As discussed in [Section 5.2](#), SEC Regulation S-X, Rule 3-05, usually requires a registrant to provide separate preacquisition historical audited financial statements for significant acquired or to be acquired businesses. However, SEC Regulation S-X, Rule 3-14, permits a registrant to provide only carve-out abbreviated income statements for significant acquired or to be acquired real estate operations.<sup>22</sup> That is, SEC Regulation S-X, Rule 3-14, does not require a registrant to present balance sheets, statements of changes in equity, or cash flow statements.

There are other differences between SEC Regulation S-X, Rules 3-14 and 3-05. For example, SEC Regulation S-X, Rule 3-14:

- Has only one significance test described in SEC Regulation S-X, Rule 1-02(w) (i.e., the investment test).
- Does not have a tiered threshold for disclosure requirements (i.e., a single 10 percent threshold results in one year of audited statements).
- Requires additional audited statements if the property acquired or to be acquired is from a related party.<sup>23</sup>

The audited abbreviated income statements described above are carve-out statements that are presented in the form of revenues and direct expenses. SEC Regulation S-X, Rule 3-14(a)(1), indicates that these statements "shall exclude items not comparable to the proposed future operations of the property such as mortgage interest, leasehold rental, depreciation, corporate expenses and Federal

<sup>21</sup> If an acquiree is identified as a predecessor or becomes a subsidiary issuer or subsidiary guarantor (see SEC Regulation S-X, Rule 3-10(g)), the audit must be performed in accordance with PCAOB standards. In certain circumstances, a reference to both auditing standards generally accepted in the United States (i.e., AICPA standards) and the standards of the PCAOB may be appropriate for a predecessor in an initial registration statement (i.e., if the entity does not meet the definition of an issuer).

<sup>22</sup> See footnote 3.

<sup>23</sup> For a definition of the term "related parties," see SEC Regulation S-X, Rule 1-02(u), which refers to the definition used in ASC 850-10-20.

and state income taxes.” In addition, since these income statements are abbreviated and meet specific requirements of SEC Regulation S-X, Rule 3-14, they are considered special-purpose financial statements. Like the audits of nonissuer entities’ financial statements filed under SEC Regulation S-X, Rule 3-05, those of nonissuer entities’ income statements filed under SEC Regulation S-X, Rule 3-14, do not need to be performed in accordance with PCAOB standards. Since these income statements are abbreviated and are designed to focus on meeting specific requirements of SEC Regulation S-X, Rule 3-14, auditors’ reports on such income statements should include an emphasis-of-matter paragraph indicating the special purpose and the incomplete nature of the presentation of the results of operations, in accordance with [AICPA Statement on Auditing Standards No. 122 \(AU-C Section 805.24\)](#).

For additional SEC interpretive guidance on SEC Regulation S-X, Rule 3-14, refer to [Topic 2](#) of the FRM.

## 5.4 Rule 3-13 Waivers

There may be situations in which registrants wish to seek relief from complying with the various reporting requirements under SEC Regulation S-X. Rule 3-13 has historically given the SEC staff the authority to permit the omission or substitution of certain financial statements otherwise required under Regulation S-X “where consistent with the protection of investors.” In recent remarks, SEC leadership encouraged registrants to seek modifications to their financial reporting requirements under Rule 3-13, particularly when the requirements are burdensome but may not be material to the total mix of information available to investors.

Examples of waiver requests under Rule 3-13 include:

- Provision of abbreviated financial statements (e.g., statement of revenues and direct expenses) in lieu of full financial statements for a recent acquiree business under Rule 3-05 (see [Section 5.2.4](#)).
- Omission of one or more years of historical financial statements for a recently acquired business subject to Rule 3-05.
- Omission of certain financial statements of an equity method investment under Rule 3-09.

For additional guidance on Rule 3-13 waivers and other requests, see Appendix B in Deloitte’s [SEC Comment Letters — Including Industry Insights](#).

# Appendix A — Template for Request to Provide Statements of Assets Acquired and Liabilities Assumed and Revenues and Direct Expenses

The template below may be used for additional guidance in preparing a request to the Office of the Chief Accountant of the Division of Corporation Finance<sup>1</sup> to present abbreviated financial statements. There are unique considerations for acquisitions of oil and gas properties, and registrants should consider the guidance in [paragraphs 2065.11](#) and [2065.12](#) of the SEC Division of Corporation Finance Financial Reporting Manual before preparing a request to the Office of the Chief Accountant of the Division of Corporation Finance to present abbreviated financial statements. This template is only a guide and should be tailored to a registrant's specific facts and circumstances.

## Company's Letterhead

[Insert date]

Mr./Ms. [Insert Name]

[Title]

Securities and Exchange Commission Division of Corporation Finance

100 F Street, N.E.

Washington, DC 20549

E-mail: [dcaoleters@sec.gov](mailto:dcaoleters@sec.gov)

Re: Request to provide Statements of Assets Acquired and Liabilities Assumed and Revenues and Direct Expenses for [insert name, "Acquiree"] to satisfy the financial statement requirements of Rule 3-05 of Regulation S-X in the Company's anticipated Form 8-K filing.

Dear [Insert Name]:

The Company, a publicly-held corporation, is a [describe nature of operations] company in the United States. As of and for the year ended [insert date], the Company had total assets of [\$x] million, shareholders' equity of [\$x] million, net revenue of [\$x] million, and net income of [\$x] million. [Provide necessary background information on Company.]

On [insert date], Company entered into an Asset Exchange Agreement with [insert name, "Owner"] to purchase Acquiree. We expect to consummate this acquisition in the [insert timeframe].

We plan to file a Form 8-K within four (4) business days subsequent to consummation of the acquisition of Acquiree. We anticipate the level of significance of Acquiree will be [insert significance level].

<sup>1</sup> For a list of whom to contact on the SEC staff for topics such as Regulation S-X, Rule 3-05, see the [Communications With the Division of Corporation Finance's Office of Chief Accountant \(CF-OCA\)](#) section of the FRM.

Accordingly, we will be required to include in the Form 8-K, audited financial statements of Acquiree for [insert financial statement periods required] pursuant to the requirements of Rule 3-05 of Regulation S-X. We plan to include these financial statements in the initial Form 8-K if the statements are available, or in an amendment to Form 8-K, within 71 calendar days from the due date of the initial Form 8-K.

The purpose of this letter is to seek the staff's concurrence with our proposed presentation of Acquiree financial statements which will be included in the Form 8-K, in satisfaction of the requirements of Rule 3-05 of Regulation S-X.

We propose to provide audited combined statements of assets acquired and liabilities assumed of Acquiree as of [insert dates], and audited combined statements of revenue and direct expenses of Acquiree for the [insert date]. In addition, we will provide unaudited financial statements of Acquiree for the interim periods [insert date] to comply with Rule 3-12 of Regulation S-X as of the filing date. We believe this proposed presentation is the most relevant and meaningful financial statement presentation for investors and other users of the financial information. The basis for our conclusion is summarized in the following section.

### **Statements of Assets Acquired and Liabilities Assumed and Statements of Revenues and Direct Expenses**

[Provide background information for Acquiree operations. Specifically, describe how Acquiree's operations relate/compare to Owner's operations. In addition, disclose the purchase price paid for Acquiree.] It is impracticable to prepare full financial statements in accordance with Regulation S-X due to the following reasons:

- Acquiree has not been accounted for as a separate entity, subsidiary or division of Owner's business.
- Owner did not manage Acquiree as a stand-alone business.
- Stand-alone financial statements of Acquiree have never previously been prepared.
- Owner does not have sufficient financial information about Acquiree. Owner has never allocated certain corporate expenses to Acquiree, including interest expense, corporate overhead expenses and income taxes. We understand that this information is not otherwise readily available and any allocation would be subjective and may not be relevant due to differences in corporate structures between Owner and the Company.

On the basis of the foregoing, we cannot compile complete balance sheet and income statement information for Acquiree. Furthermore, because we cannot compile complete balance sheet and income statement information, we also cannot prepare a statement of cash flows for Acquiree.

We request your concurrence with our proposal to present the following financial information relating to Acquiree in satisfaction of the requirements of Rule 3-05 of Regulation S-X:

- Statements of Revenues and Direct Expenses for Acquiree for the [insert date] pursuant to the requirements of Rule 3-05 of Regulation S-X. These statements will include revenues, less expenses, directly attributable to Acquiree. Direct expenses include sales and marketing, depreciation and other administrative costs directly associated with the revenue producing activities of Acquiree, and would exclude only costs that are not directly involved in the revenue producing activity, such as corporate overhead, interest, and taxes.
- Statements of Assets Acquired and Liabilities Assumed as of [insert dates], pursuant to the requirements of Rule 3-05 of Regulation S-X. This Statement will consist only of the assets acquired and liabilities assumed. Pursuant to the Asset Exchange Agreement, the Company will only acquire [describe assets acquired]. No other assets or liabilities will be acquired or assumed by the Company.

- Unaudited financial statements (as defined above) for the interim periods [insert date] to comply with Rule 3-12 of Regulation S-X.
- To the extent available, we will provide selected cash flow information about operating, investing, and financing cash flows relating to the Acquiree in the notes to the financial statements.
- In the notes to Acquiree financial statements, we will disclose (1) management's assertion that the allocation method used is reasonable; (2) the basis of presentation, including the nature of the omitted expenses and the reasons for their omission; (3) an explanation of the impracticability of providing full financial statements; and (4) that the financial statements presented are not indicative of financial condition or results of operations of the acquiree because operating expenses have been omitted.

## Conclusion

We believe the presentation of the abbreviated financial information described above would provide investors with all of the information material to their understanding of our acquisition of Acquiree.

Please contact me at [insert phone number and e-mail address] to discuss any additional information you may need in order to conclude on this issue. Thank you for your consideration of this matter.

Sincerely,

[Insert Name]  
Chief Financial Officer

# Appendix B — Titles of Standards and Other Literature

The following are the titles of standards and other literature mentioned in this publication:

## **AICPA Literature**

AICPA Statement on Auditing Standards No.122 (AU-C Section 805.24), *Reporting on an Incomplete Presentation but One That Is Otherwise in Accordance With Generally Accepted Accounting Principles*

## **FASB Accounting Standards Codification (ASC) Topics**

ASC 205, *Presentation of Financial Statements*

ASC 225, *Income Statement*

ASC 230, *Statement of Cash Flows*

ASC 250, *Accounting Changes and Error Corrections*

ASC 260, *Earnings per Share*

ASC 275, *Risks and Uncertainties*

ASC 280, *Segment Reporting*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 420, *Exit or Disposal Cost Obligations*

ASC 450, *Contingencies*

ASC 460, *Guarantees*

ASC 505, *Equity*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 740, *Income Taxes*

ASC 805, *Business Combinations*

ASC 845, *Nonmonetary Transactions*

ASC 850, *Related Party Disclosures*

ASC 855, *Subsequent Events*

## **FASB Accounting Standards Updates (ASUs)**

ASU 2017-09, *Compensation — Stock Compensation (Topic 718): Scope of Modification Accounting*

ASU 2016-09, *Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*

ASU 2014-17, *Business Combinations (Topic 805): Pushdown Accounting* — a consensus of the FASB Emerging Issues Task Force

ASU 2013-12, *Definition of a Public Business Entity — An Addition to the Master Glossary*

## **SEC Staff Accounting Bulletins (SABs)**

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

Topic 5.J, "New Basis of Accounting Required in Certain Circumstances" (rescinded by SAB 115)

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 S-K**

Item 301, "Selected Financial Data"

Item 302, "Supplementary Financial Information"

Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

## **SEC Regulation S-X**

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

Rule 3-01, "Consolidated Balance Sheets"

Rule 3-02, "Consolidated Statements of Income and Changes in Financial Positions"

Rule 3-03, "Instructions to Income Statement Requirements"

Rule 3-04, "Changes in Stockholders' Equity and Noncontrolling Interests"

Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired"

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

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

Rule 3-12, "Age of Financial Statements at Effective Date of Registration Statement or at Mailing Date of Proxy Statement"

Rule 3-13, "Filing of Other Financial Statements in Certain Cases"

Rule 3-14, "Special Instructions for Real Estate Operations to Be Acquired"

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

Rule 4-08, "General Notes to Financial Statements"

Article 5, "Commercial and Industrial Companies"

Rule 5-02, "Balance Sheets"

Rule 5-04, "What Schedules Are to Be Filed"

Rule 10-01, "Interim Financial Statements"

Article 11, "Pro Forma Financial Information"

Rule 11-01, "Presentation Requirements"

Article 12, "Form and Content of Schedules"

### **SEC Division of Corporation Finance's Financial Reporting Manual (FRM)**

Topic 2, "Other Financial Statements Required"

Topic 3, "Pro Forma Financial Information"

Topic 6, "Foreign Private Issuers and Foreign Businesses"

Topic 9, "Management's Discussion and Analysis of Financial Position and Results of Operations (MD&A)"

Topic 10, "Emerging Growth Companies"

## Appendix C — Abbreviations

Abbreviation	Description
<b>AICPA</b>	American Institute of Certified Public Accountants
<b>AOCI</b>	accumulated other comprehensive income
<b>ASC</b>	FASB Accounting Standards Codification
<b>ASU</b>	FASB Accounting Standards Update
<b>C&amp;DI</b>	SEC Compliance and Disclosure Interpretation
<b>CF-OCA</b>	SEC's Division of Corporation Finance, Office of the Chief Accountant
<b>CODM</b>	chief operating decision maker
<b>DTA</b>	deferred tax asset
<b>DTL</b>	deferred tax liability
<b>EGC</b>	emerging growth company
<b>EPS</b>	earnings per share
<b>FASB</b>	Financial Accounting Standards Board
<b>FRM</b>	SEC Division of Corporation Finance's Financial Reporting Manual
<b>GAAP</b>	generally accepted accounting principles

Abbreviation	Description
<b>GAAS</b>	generally accepted auditing standards
<b>ICFR</b>	internal control over financial reporting
<b>IPO</b>	initial public offering
<b>IT</b>	information technology
<b>LLC</b>	limited liability company
<b>MD&amp;A</b>	Management's Discussion & Analysis
<b>PBE</b>	public business entity
<b>PCAOB</b>	Public Company Accounting Oversight Board
<b>PCC</b>	Private Company Council
<b>PP&amp;E</b>	property, plant, and equipment
<b>R&amp;D</b>	research and development
<b>SAB</b>	SEC Staff Accounting Bulletin
<b>SEC</b>	U.S. Securities and Exchange Commission
<b>SG&amp;A</b>	selling, general, and administrative

The following is a list of short references for the Acts mentioned in this publication:

Abbreviation	Act
<b>ERISA</b>	Employee Retirement Income Security Act of 1974
<b>Exchange Act</b>	Securities Exchange Act of 1934
<b>JOBS Act</b>	Jumpstart Our Business Startups Act
<b>Sarbanes-Oxley Act</b>	Sarbanes-Oxley Act of 2002
<b>Securities Act</b>	Securities Act of 1933