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On the Radar
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, initial public offering, or special-purpose acquisition company transaction involving a portion of the parent entity. Carve-out financial statements are necessary 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.

Management Considerations

Management often may need to use judgment and carefully plan ahead when preparing carve-out financial statements since such a process can be challenging. Considerations management should take into account when preparing carve-out financial statements include the following:

- *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).

- *Materiality and evaluating misstatements* — Because the materiality thresholds related to the carve-out financial statements will most likely be lower than those related to the consolidated parent entity, management may need to assess the carve-out entity's accounts and balances more closely than the parent's. The parent entity's historical corrected or uncorrected misstatements and disclosures related to the carve-out entity that were previously considered immaterial to the parent's financial statements would need to be reconsidered on the basis of materiality thresholds applicable to the carve-out financial statements.
- *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.
- *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 selling, general, and administrative expenses).

  Management may choose to use existing accounting systems as much as possible when preparing carve-out financial statements. However, the ability to use such systems may be limited 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.
- *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 such preparation. 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 include (1) identifying the carve-out entity and the carve-out entity's financial statements, (2) materiality and evaluating misstatements, (3) internal control over financial reporting, and (4) significant management judgments and accounting estimates.

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, carve-out financial statements might be in the form of (1) public-entity financial statements subject to SEC requirements, (2) nonpublic-entity financial statements to which certain U.S. GAAP presentation and disclosure requirements do not apply and for which reporting alternatives developed by the Private Company Council may be elected, and (3) special-purpose financial information that a user may ask for in a specific form or for it to be prepared in accordance with another comprehensive basis of accounting.

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

The business or activities associated with 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, there are expected to be complexities associated with 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. Such complexities are particularly likely when the business of the carve-out entity has not been organized separately within the larger parent entity and when significant assets, liabilities, and operations are shared with other businesses.

Carve-out financial statements should include disclosures about the basis of presentation that give 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).

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]). Balance sheet items that are inherently related to the carve-out entity, such as PP&E, can often be readily attributed to the carve-out financial statements. For many of the balances, however, balance sheet items may not be easily identified (e.g., 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). More complex balance sheet items might include goodwill, parent-entity debt, defined benefit plans, derivatives and hedging, and contingencies. For assets and liabilities for which specific guidance does not exist, entities should use a reasonable allocation method.

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 when management is determining the appropriate allocation of certain expenses to the carve-out entity.

Accounting Considerations Related to a Carve-Out Entity's 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).

SEC Reporting Topics

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 users or any applicable regulations. Circumstances in which carve-out financial statements may be requested (or required) to meet the SEC's requirements include, but are not limited to, the following:

- *Registrant and its predecessor* — For inclusions in an initial registration statement (e.g., Form 10, Form S-1) and when provided in Forms 10-K and 10-Q after the initial registration statement is declared effective.
- *Businesses acquired or to be acquired* — When a registrant acquires, or it is probable that it will acquire, a significant business (acquiree).
- *Acquired or to be acquired real estate operations* — When a registrant acquires, or it is probable that it will acquire, significant real estate operations.

There may be situations in which registrants wish to seek relief from complying with the various reporting requirements under SEC Regulation S-X. 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." Further, the SEC has historically 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. While many of the recent amendments to the SEC rules are intended to modernize the requirements and are expected to reduce the number of waivers granted, registrants may still seek modifications to their reporting requirements under Rule 3-13 since the SEC staff continues to entertain those requests.

Deloitte's Roadmap *Carve-Out Transactions* provides a comprehensive discussion of key factors for entities to consider as they prepare their carve-out financial statements.

Contacts

Michael Morrissey
Partner
Deloitte & Touche LLP
+1 203 761 3630
mmorrissey@deloitte.com

Ignacio Perez
Managing Director
Deloitte & Touche LLP
+1 203 761 3379
igperez@deloitte.com

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