Deloitte.

September 2023

# On the Radar

## Carve-Out Financial Statements

“Carve-out financial statements” is a general term used to describe financial statements derived from the financial statements of a larger parent entity. Such statements are often required when a parent entity wishes to pursue a sale, spin-off, initial public offering (IPO), or special-purpose acquisition company (SPAC) transaction involving a portion of the parent entity. In addition, they are necessary in various types of transactions as a means of reflecting the portion of a parent entity’s balances and activities that are being “carved out.” Certain SEC staff guidance addresses some elements of carve-out financial statements (e.g., when to include them 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 source of comprehensive guidance on preparing carve-out financial statements.

The volume of IPO and SPAC transactions has decreased since reaching record levels in 2020 and 2021; however, divestiture activity (for which carve-out financial statements are often required) remains strong. As noted in Deloitte’s *Divestitures Quarterly Update — Q2 2023*, the number of divestiture deals grew by 85 percent quarter on quarter, while overall merger and acquisition activity grew by only 11 percent. At the same time, private equity buyers’ interest in divestitures grew significantly, with private equity accounting for 29 percent of the buyers in the second quarter of 2023 compared with 2 percent in the first quarter.

Providing complete and accurate carve-out financial statements in a timely manner can be key to the success of a divestiture transaction. Accordingly, some key management considerations and common pitfalls associated with preparing such statements are discussed below.

## Key Management Considerations and Common Pitfalls Associated With Preparing Carve-Out Financial Statements

Preparing carve-out financial statements can be challenging, often requiring management to use judgment and carefully plan ahead. Factors and common pitfalls for management to consider when preparing these statements include the following:

- *Assembling the right team* — Involving the appropriate personnel is an integral step in preparing accurate and complete carve-out financial statements. Management should determine which employees can help provide the information it needs to prepare such statements, which may include individuals outside accounting (e.g., in operations or human resources) as well as those involved in negotiating the transaction. In addition, management may need to engage external specialists (e.g., tax or valuation experts).
- *Determining the transaction's structure and scope* — In many divestiture transactions, planning for and preparing carve-out financial statements starts before the final transaction structure is determined or negotiations begin. Identifying the expected structure and which entities or operations will be included within it is a key step in developing the carve-out financial statements. Such financial statements may 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 may request to be prepared in accordance with another comprehensive basis of accounting. Thus, the transaction structure can affect the form and content of the financial statements, the years to be provided, and the audit procedures required.

> ***Common pitfall* — A lack of communication between the deal team and the preparers of the carve-out financial statements may result in late revisions to such statements because of changes in the structure and scope of the transaction.**

- *Materiality and evaluating misstatements* — Because the materiality thresholds related to the carve-out financial statements will most likely be lower than those associated with the consolidated parent entity, management may need to assess the carve-out entity's accounts and balances in even more detail than they may have been subjected to during preparation of the parent entity financial statements. 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). In other cases, intercompany transactions may have historically been eliminated within the

parent's financial statements; however, those transactions would be reported in the carve-out financial statements, and appropriate supporting documentation would be required.

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.

***Common pitfall* — Failing to identify the appropriate level of granularity needed in transaction records and support for carve-out financial statements may result in delays and rework.**

- *Significant judgments and estimates* — In preparing carve-out financial statements, management will often need to make significant accounting judgments and estimates related to allocating account balances and activities to the carve-out financial statements and determining the appropriate disclosures to include in these financial statements. Significant estimates include (1) the allocation of goodwill or intangible assets, employee benefits (including pension and postretirement obligations), shared assets, corporate expenses, and income taxes; (2) the identification of operating and reportable segments; and (3) the evaluation of subsequent events.

***Common pitfall* — Inadequate documentation and disclosure of key judgments can lead to questions and comments during the audit or SEC review process, if applicable.**

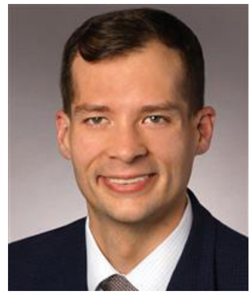
- *Working with auditors* — If, as part of the preparation of carve-out financial statements, external auditors need to perform an audit and issue an audit opinion, the auditors will need to understand the process undertaken by management for collecting and maintaining all supporting documentation used 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.

***Common pitfall* — Failure to identify a requirement for an audit early in the process or to maintain close communication between the deal team and the preparers of the carve-out financial statements may result in delays.**

Deloitte's Roadmap *Carve-Out Financial Statements* provides financial reporting, accounting, and auditing considerations to help companies navigate challenges related to preparing carve-out financial statements.

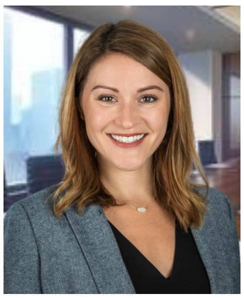
## Contacts

**Matt Himmelman**
Audit & Assurance Partner
Deloitte & Touche LLP
+1 714 436 7277
mhimmelman@deloitte.com



**Doug Rand**
Audit & Assurance
Managing Director
Deloitte & Touche LLP
+1 202 220 2754
dorand@deloitte.com

For information about Deloitte's service offerings related to carve-out financial statements, please contact:



**Jamie Davis**
Audit & Assurance Partner
Deloitte & Touche LLP
+1 312 486 0303
jamiedavis@deloitte.com

## Dbriefs for Financial Executives

We invite you to participate in Dbriefs, Deloitte's live webcasts that give you valuable insights into important developments affecting your business. Topics covered in the Dbriefs for Financial Executives series include financial reporting, tax accounting, business strategy, governance, and risk. Dbriefs also provide a convenient and flexible way to earn CPE credit — right at your desk.

## Subscriptions

To subscribe to Dbriefs, or to receive accounting publications issued by Deloitte's Accounting and Reporting Services Department, please register at My.Deloitte.com.

## The Deloitte Accounting Research Tool

Put a wealth of information at your fingertips. The Deloitte Accounting Research Tool (DART) is a comprehensive online library of accounting and financial disclosure literature. It contains material from the FASB, EITF, AICPA, PCAOB, and SEC, in addition to Deloitte's own accounting manuals and other interpretive guidance and publications.

Updated every business day, DART has an intuitive design and navigation system that, together with its powerful search and personalization features, enable users to quickly locate information anytime, from any device and any browser. While much of the content on DART is available at no cost, subscribers have access to premium content, such as Deloitte's *FASB Accounting Standards Codification Manual*. DART subscribers and others can also subscribe to *Weekly Accounting Roundup*, which provides links to recent news articles, publications, and other additions to DART. For more information, or to sign up for a free 30-day trial of premium DART content, visit dart.deloitte.com.