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Carve-out financial statements

Partially updated April 2024

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About the Carve-out financial statements guide

PwC is pleased to offer our *Carve-out financial statements* guide. This guide discusses the requirements, methodologies, and practical considerations when preparing carve-out financial statements. It also includes a discussion of related presentation and disclosure matters.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Business combinations and noncontrolling interests (BCG)*
- *Financial statement presentation (FSP)*
- *Foreign currency (FX)*
- *Income taxes (TX)*
- *Stock-based compensation (SC)*

Summary of significant changes

Following is a summary of recent noteworthy revisions to this guide. Additional updates may be made to future versions to keep pace with significant developments.

Revisions made in January 2024

CO 4, *Balance sheet methodology*

- **CO 4.2.2.1** was added to clarify the application of ASC 326, Financial Instruments – Credit Losses.

Revisions made in February 2023

CO 5, *Income statement methodology*

- **CO 5.4.2** was updated to clarify the financial statement presentation of an imputed charge to a parent entity.

- **CO 5.10** was updated to provide guidance on accounting for bonuses paid to employees of a carve-out entity.

CO 6, *Disclosures and certain presentation matters*

- **CO 6.5A** was removed since the amendments to Regulation S-X, Article 11 are now effective for all companies.

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Chapter 1: Introduction to carve-out financial statements—updated October 2023

1.1 Carve-out financial statements—overview

Businesses have a life cycle and transition through phases, from initial launch through maturity. During the various phases, businesses may create shareholder value through strategic transactions. One type of strategic transaction is a divestiture. Forms of divestitures include the sale, spinoff, or split-off of a business, or an initial public offering. See CO 1.3 for a discussion on common exit strategies.

The divestiture of a business may require the preparation of either consolidated or combined financial statements, depending upon the structure of the transaction, parties involved, and associated capital raising activities, as applicable. When the net assets and results of operations of the business are carved out of a larger entity, these financial statements are referred to as "carve-out" financial statements.

1.2 Purpose of carve-out financial statements

There is no legal or accounting definition for carve-out financial statements. Rather, carve-out financial statements reflect the separate financial results and financial position of a portion of a larger entity, which can take the form of a subsidiary, an operating unit, a product line, or a brand. The financial statements presented may or may not be of a legal entity, which can lead to complexities in the basis of presentation of carve-out financial statements.

When determining whether carve-out financial statements are needed, the reporting entity should consider the nature of the planned divestiture, including any contractual or SEC reporting requirements. Often, the completion of a transaction or the related deal financing can be contingent on providing carve-out financial statements.

When the carve-out financial statements are to be included in an SEC filing, applicable SEC rules will determine the form of the filing, the annual and interim financial statements required, the age of the financial statements, and whether the financial statements need to be audited.

Figure CO 1-1 provides an overview of different types of SEC forms and when they may be required.

Figure CO 1-1
Typical SEC forms used in certain divestiture transactions

SEC form	Purpose/Use
S-1/F-1	□ Registration statement used by first-time Securities Act registrants for purposes of an initial public offering of a carve-out entity.
S-4/F-4	□ Used to register securities issued by the acquirer in exchange for securities of the acquiree in the acquisition. □ Detailed financial information about the target is often required, including but not limited to interim and annual financial statements, pro forma financial information, and MD&A.

SEC form	Purpose/Use
8-K	▫ Used to inform shareholders about various material corporate events, including significant acquisitions or dispositions of businesses. ▫ If an acquisition has occurred, and it meets certain significance thresholds defined by the SEC, the acquirer may be required to include the carve-out financial statements of the acquired entity pursuant to Regulation S-X Rule 3-05 or Regulation S-X Rule 8-04.
10	▫ Often used to register shares of a subsidiary (may be newly created) that are subsequently distributed to the parent company's shareholders (i.e., a spinoff transaction).
S-11	▫ Used to register securities issued by real estate investment trusts or other issuers whose business is primarily that of acquiring and holding for investment real estate.

When financial statements are prepared to satisfy SEC requirements, the number of periods required to be presented will be dictated by the applicable SEC regulations, including Regulation S-X Rule 3-05 or Regulation S-X Rule 8-04. In certain cases, the determination of how many periods to present is based on significance thresholds. These thresholds are based on specific quantitative metrics that determine the level of significance of the acquired entity in comparison to the acquirer.

When the financial statements are not required to be filed with the SEC, the number of periods presented and form of carve-out financial statements varies based on the needs and specifications of the parties to the transaction.

1.3 Common exit strategies

Corporate exit strategies seek to maximize shareholder value. Common exit strategies include the sale of a business (see CO 1.3.1), spinoff (see CO 1.3.2), split-off (see CO 1.3.3), and initial public offering (see CO 1.3.4). The reasons why a reporting entity may pursue a particular strategy are discussed in the referenced sections.

1.3.1 Sale of a business

The most common way of divesting a business is a sale transaction in which a business is "carved out" and sold to a buyer.

From the seller's perspective, the sale of a business can provide needed cash, and often has less onerous SEC filing requirements than other options, such as a spinoff or split-off transaction.

From the buyer's perspective, the purpose for acquiring the business may vary. Strategic buyers often purchase a business because it complements an existing business or offers operational synergies. Financial buyers, such as private equity firms, typically purchase a business with the intent of increasing its value through further development or restructuring with the plan to divest the acquired business via sale or initial public offering in a specific timeframe.

Financial statement requirements are principally driven by the acquirer's due diligence, financing (including offerings under 144A), or SEC reporting requirements. Specifically, an acquirer may be

required to file a Form S-4[1] or a Form 8-K which includes the carve-out financial statements for the business being acquired. The requirements of Form S-4 with regard to target disclosures are more extensive than those required for an acquired business reported on Form 8-K.

Divestiture transactions may be subject to reporting requirements by the acquirer if the parts to be divested meet the definition of a business as defined in Regulation S-X Rule 11-01(d). For example, if a registrant acquires a business and certain significance thresholds are met, a Form 8-K will need to be filed that includes financial statements in accordance with Regulation S-X Rule 3-05 or Regulation S-X Rule 8-04.

While many divestiture transactions will meet the definition of a business, certain transactions will not. SEC Regulation S-X Article 11-01(d) defines a business.

Regulation S-X Article 11-01(d)

For purposes of this rule, the term business should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity's operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business. However, a lesser component of an entity may also constitute a business. Among the facts and circumstances which should be considered in evaluating whether an acquisition of a lesser component of an entity constitutes a business are the following:

(1) Whether the nature of the revenue-producing activity of the component will remain generally the same as before the transaction; or

(2) Whether any of the following attributes remain with the component after the transaction:

(i) Physical facilities,

(ii) Employee base,

(iii) Market distribution system,

(iv) Sales force,

(v) Customer base,

(vi) Operating rights,

(vii) Production techniques, or

(viii) Trade names.

The SEC guidance includes a presumption that a legal entity or division is a business. However, a component can also be a business if any of the criteria above are met. The SEC's definition of a business is not consistent with the FASB's definition of a business in ASC 805, *Business*

[1] References herein are based on a domestic filer. Foreign private issuers would file the applicable form (e.g., F-4) with the SEC.

Combinations. As a result, it is possible different conclusions may be reached for accounting purposes. If the transaction is a business under the SEC definition, financial statements may be required to be filed with the SEC even though for accounting purposes the acquisition will be accounted for as an asset acquisition rather than a business combination.

Section 2010.3 through 2010.6 of the SEC's Financial Reporting Manual (FRM) provides additional guidance around the determination of whether a transaction constitutes a business.

SEC FRM 2010.3 An investment accounted for under the equity method - The staff considers the acquisition of an investment accounted for under the equity method to be a business for reporting purposes.

SEC FRM 2010.4 A working interest in an oil and gas property - The staff considers the acquisition of a working interest in an oil and gas property to be a business for reporting purposes. Refer to Section 2065.11 "Unique Considerations for Acquisitions of Oil and Gas Properties – General." (Last updated: 10/20/2014)

SEC FRM 2010.5 Bank branch acquisitions - The assumption of customer deposits at bank branches may constitute the acquisition of a business if historical revenue producing activity is reasonably traceable to the management or customer and deposit base of the acquired branches, and that activity will remain generally the same following the acquisition.

SEC FRM 2010.6 Insurance policy acquisitions - Acquisitions of blocks of insurance policies by an insurance company or the assumption of policy liabilities in reinsurance transactions may also be deemed the acquisition of a business because the right to receive future premiums generally indicates continuity of historical revenues. The degree of continuity between historical investment income streams and the assets acquired to fund the acquired policy liabilities should also be considered.

1.3.2 Spinoff

A spinoff typically refers to the pro rata distribution of a subsidiary's stock (the SpinCo) to the parent company's shareholders. The effect of this transaction is to "dividend off" or "carve out" a piece of the company to its existing shareholders. Thus, the SpinCo becomes a stand-alone company with its own equity structure. These transactions may be referred to as "one-step spinoffs." ASC 505-60-20 defines a spinoff.

Definition from ASC 505-60-20

Spinoff: The transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor.

SEC reporting companies typically use spinoff transactions to enable the separate businesses to more readily pursue individual long-term strategic goals. Additionally, companies often use spinoffs as a tax-free mechanism to unlock value for shareholders. A spinoff transaction does not raise capital for the parent or the spun off entity. A parent might raise debt in SpinCo's name prior to, or in conjunction with, the spinoff and retain the cash as a way to monetize its divestiture of SpinCo; however, this is a separate transaction preceding the spinoff. After the spinoff, the shareholders own shares in two entities, and the overall value held by the shareholders typically does not change immediately. Although a spinoff is not a sale of securities, the SpinCo's newly-issued shares are

registered with the SEC. This is typically accomplished by filing a Form 10 for the SpinCo, which generally includes historical stand-alone, carve-out financial statements for the SpinCo and other required historical and pro forma financial information.

A "two-step spinoff" occurs when a parent offers securities in the SpinCo through an initial public offering prior to executing a pro rata distribution to the parent's shareholders. Companies use these transactions as a way to build brand value and to fund the working capital requirements prior to the separation from the parent entity. Two-step spinoffs are typically undertaken to monetize value in a subsidiary while still retaining control and an interest in its future value. Frequently, the initial public offering is for a less than 20% ownership interest in the SpinCo in order to achieve a tax-free spinoff in accordance with Internal Revenue Code Section 355. The first step in a two-step spinoff (the initial public offering) is an offer of securities to the public requiring the filing of Form S-1 with the SEC. The second step is the distribution by the parent of its holding of the subsidiary shares to the parent's shareholders.

In unique circumstances, the substance of a spin-off transaction does not match its legal form, such that the new legal spinee will be the continuing entity. In this type of transaction, known as a reverse spin-off, the determination of the accounting spinee and spinnor can become quite complicated, such that specific attention and significant judgment is required to determine the appropriate financial statement presentation.

1.3.3 Split-off

A split-off is a transaction in which the parent entity gives its stockholders the opportunity to exchange some (or all) of their parent entity stock for an interest in one of its subsidiaries (i.e., the carve-out business). This type of transaction is described in ASC 845-10-20.

The principal difference between a spinoff and a split-off is that after completion of a split-off, the subsidiary's stock is held by the parent's stockholders on a non-pro rata basis. Some stockholders may hold only parent stock; others may hold only subsidiary stock; and others may hold both.

Some companies may choose a split-off over a spinoff because a split-off gives stockholders an option to participate. This flexibility may be important when stockholders holding a significant interest express a preference for one stock over the other.

Exchange offers typically require the filing of a Form S-4. Like a one-step spinoff, the split-off transaction is not a capital-raising transaction. Similar to a two-step spinoff, a split-off can also be preceded by an initial public offering of securities of the carve-out business to the public (typically no greater than 20%).

1.3.4 Initial public offering

In an initial public offering, a parent company may carve-out a portion of itself to create a new company to be traded on a public exchange. This exit strategy allows a company to raise capital quickly from numerous public investors. This cash can then be used for various purposes, including to reinvest in the company, settle outstanding debt, or generate capital for future growth.

The typical filing requirement is a Form S-1, which requires up to three years of audited financial statements. Financial reporting requirements are reduced if the business qualifies as an emerging growth company or a smaller reporting company.

1.4 Applicable guidance

US GAAP does not provide guidance on preparing carve-out financial statements. Certain SEC staff guidance addresses specific elements of carve-out financial statements. Additionally, while the SEC guidance is applicable only to public entities, it is often analogized to when preparing carve-out financial statements for non-public entities. SEC guidance applicable to the preparation of carve-out financial statements includes:

- SEC FRM 2065, *Acquisition of Selected Parts of an Entity may Result in Less than Full Financial Statements*
- SAB Topic 1.B, *Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity*
- SAB Topic 5.Z.7, *Accounting for the spin-off of a subsidiary, codified as ASC 505-60-S99-1*.

Chapter 2: Requirements for carve-out financial statements—updated October 2023

2.1 Identification of the carve-out business

To prepare carve-out financial statements, management must first determine what is being divested. This determination impacts the operations and assets and liabilities included in the financial statements and the costs to be allocated.

There are generally two approaches used to prepare carve-out financial statements: a legal entity approach and a management approach. Determining which approach to apply depends on the facts and circumstances of the transaction.

Factors that impact how the carve-out financial statements are prepared include:

- the purpose of the transaction,
- the legal structure of the transaction (e.g., whether shares of a legal entity or the net assets of a business are being divested),
- the form of the transaction (e.g., spinoff or sale),
- whether or not certain net assets and results of operations retained by the parent can be excluded on a retroactive basis (i.e., a "depooling") from the historical financial statements, and
- The portion of the legal entity that is being acquired/divested relative to the portion that is not being acquired/divested.

If the form of the transaction has not been determined, the reporting entity may need to consider each of the possible outcomes, and the reporting requirements of each outcome.

2.1.1 Legal entity approach

The legal entity approach is often appropriate in circumstances when the transaction structure is aligned with the legal entity structure of the divested entity. One example would be when shares of a legal entity or a consolidated group of legal entities are divested.

If it is determined that the legal entity approach is appropriate, all historical results of the legal entity, including those that are not ultimately transferred, should be presented in the historical financial statements through the date of transfer. If the historical results of operations of the carve-out entity include legal entities that will not ultimately be divested, the operations remaining with the parent company should be assessed under ASC 205-20, *Discontinued Operations*. See Example CO 6-2 for an example of how a carve-out business assesses the discontinued operations criteria related to operations that are part of the historical results of the carve-out business but will remain with the parent.

A legal entity approach is typically used when the transaction is a spinoff or IPO and the “depooling” criteria of SAB Topic 5.Z.7, *Accounting for the spin-off of a subsidiary*, codified as ASC 505-60-S99-1, are not met (see CO 2.1.3). Additionally, a legal entity approach may be used when a transaction between a private operating entity and a blank-check company is accounted for as a reverse recapitalization or a transaction is a sale of substantially all of the legal entity (see CO 2.1.4).

2.1.2 *Management approach*

In some circumstances, utilizing a legal entity approach may not be appropriate or may not provide the most meaningful presentation of financial information to the users of the carve-out financial statements. This may be the case when net assets that constitute a business, rather than a legal entity, are being divested, or when the legal structure of an entity does not align with the business being sold. The management approach takes into consideration the assets that are being transferred to determine the most appropriate financial statement presentation.

A management approach may also be appropriate when a parent entity needs to prepare financial statements for the sale of a legal entity, but prior to divestiture, certain significant operations of the legal entity are contributed to the parent in a common control transaction.

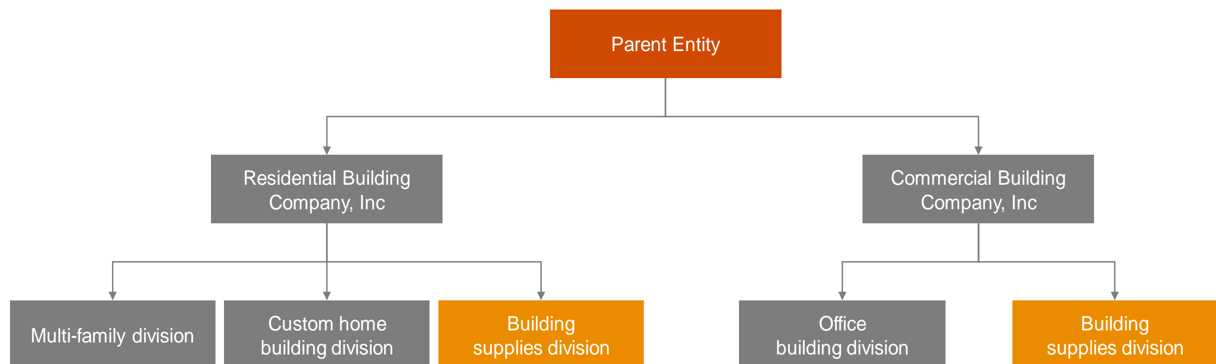
A management approach is typically used when (1) the transaction is a spinoff, IPO, or transaction between a private operating company and a blank-check company that is accounted for as a reverse recapitalization, and the "depooling" criteria of SAB Topic 5.Z.7 are met (see CO 2.1.3), (2) the transaction is a sale that does not represent substantially all of the legal entity (see CO 2.1.4), or (3) the transaction is the divestiture of net assets (or a combination of net assets and legal entities).

Example CO 2-1 illustrates the application of the management approach.

EXAMPLE CO 2-1

Applying the management approach

Parent Entity operates in the construction industry through two subsidiaries, Residential Building Company Inc. and Commercial Building Company Inc., each of which is a separate legal entity. Residential Building Company Inc. and Commercial Building Company Inc. are comprised of several divisions. Parent Entity plans to sell the supply divisions of Residential Building Company Inc. and Commercial Building Company Inc. to a buyer.



What operations should be included in the historical financial statements of the carve-out business?

Analysis

The planned transaction is not a divestiture of legal entities. Accordingly, a management approach in which the presentation of the operations and net assets of the residential and commercial building supply divisions are combined would be appropriate. The resulting financial statements will be labeled combined. See CO 5.2 for guidance on whether an allocation of corporate costs from Residential

Building Company Inc., Commercial Building Company Inc., and/or Parent Entity would need to be reflected in the financial statements.

2.1.3 *Depooling a dissimilar business*

If the transaction is an IPO or spinoff of a preexisting legal entity, whether to use the legal entity or the management approach is based on whether or not certain net assets and results of operations retained by the parent can be excluded on a retroactive basis (i.e., a "depooling") from the historical financial statements. SAB Topic 5.Z.7 provides the criteria for this evaluation. If the criteria are met, the entity may elect to apply the management approach, presenting only the net assets and operations included in the IPO or spinoff. If the criteria are not met, the entity should apply the legal entity approach.

For the retained business to be separated, or depooled, from the business that will be spun-off, one requirement in SAB Topic 5.Z.7 is that they are “dissimilar.” Our experience is that to meet this requirement, the businesses must be significantly different, such as when one business is a car wash and the other is a bank. If the reporting entity cannot separate the two businesses because they are not sufficiently dissimilar, then the business that will not be included in the transaction is included in the carve-out financial statements. Notwithstanding, the business that is not part of the IPO or spinoff transaction may be reflected as a discontinued operation under ASC 205-20 if those criteria are met. See FSP 27.4.3.1. Further, pro forma financial information required to be presented under Regulation S-X Article 11 may need to reflect the divestiture of assets or depooling of businesses that were included in the carve-out financial statements, but will not be transferred in connection with the transaction. See CO 6.5.

In addition to being in dissimilar businesses, SAB Topic 5.Z.7, requires the reporting entity to consider if each of the following criteria are met:

- The businesses have been managed and financed historically as if they were autonomous;
- The businesses have no more than incidental common facilities and costs;
- The businesses will be operated and financed autonomously after the transaction; and
- The businesses will not have material financial commitments, guarantees, or contingent liabilities to each other after the transaction.

Example CO 2-2 provides an example of the application of SAB Topic 5.Z.7 when part of the legal entity is retained by the Parent entity.

EXAMPLE CO 2-2

Applying the legal entity approach when part of the legal entity is retained

Company X is a diversified financial services company with operations in a number of lines of business. Company X operates its insurance business (life insurance and auto insurance) through its wholly-owned subsidiary, Subsidiary S. The life insurance and auto insurance divisions each have their own customer base and distribution channel.

Subsidiary S intends to file a registration statement in connection with an IPO. Prior to completing the IPO, Company X intends to transfer the automobile insurance operations from Subsidiary S's legal structure to another legal entity within the Company X group.

Can Subsidiary S present its financial statements in the IPO prospectus as if Subsidiary S had never legally owned the automobile insurance company (i.e., "depool" the automobile insurance business and recast all prior periods)?

Analysis

Given the transaction is an IPO of a preexisting legal entity, the use of the legal entity or the management approach is based on whether the net assets and results of operations retained by the parent can be excluded on a retroactive basis (i.e., a "depooling") from the historical financial statements. SAB Topic 5.Z.7 provides the criteria for this evaluation and all the criteria should be evaluated. Although the businesses are dissimilar with respect to the nature of the customer risks being insured and the marketing channels utilized, the underlying business of both entities involve insurance. Because they are both in the insurance business, they would likely be viewed as similar for purposes of applying SAB Topic 5.Z.7. As such, Subsidiary S would reflect the ownership of the automobile insurance company in its financial statements and should not depool these operations. If the criteria for discontinued operations presentation are met, the automobile insurance company would be reflected as a discontinued operation.

2.1.4 Substantially all of the legal entity

If the transaction is a sale of a preexisting legal entity, and is not an IPO or spin transaction, then the determination of whether the legal entity or management approach should be used is based on whether the divested business represents “substantially all” of the legal entity. SEC FRM 2065.1 through SEC FRM 2065.2 provide the guidance for this evaluation. If the divested business represents “substantially all” of the legal entity, the entity should apply the legal entity approach. If the divested business does not represent “substantially all” of the legal entity, the entity should apply the management approach.

SEC FRM 2065.1 Acquire *Substantially All* of an Entity –

If the registrant acquires or succeeds to substantially all of the entity's key operating assets, 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 these circumstances, elimination of specified assets and liabilities not acquired or assumed by the registrant is depicted in pro forma financial statements presenting the effects of the acquisition.

SEC FRM 2065.2 Acquire *Less than* *Substantially All* of an Entity – In some circumstances, a registrant does not acquire or succeed to substantially all of the assets and liabilities of another entity. For example, the selling entity may retain significant operating assets, or significant operating assets that comprised the seller may continue to be operated by an entity other than the registrant. In these circumstances, financial statements of the larger entity of which the acquired business was a part may not be informative. In that case, audited financial statements usually should be presented for the acquired component business, excluding the continuing operations retained by the larger entity. Registrants should evaluate their facts and circumstances to determine whether to apply the guidance in Section 2065.3 (carve-out financial statements) or in Sections 2065.4 through Section 2065.12 (abbreviated financial statements).

There is not a bright line test to make the substantially all assessment. Rather, it requires judgment and is based on the particular facts and circumstances. The analysis might consider a comparison of financial metrics (such as total assets, revenue, operating income, pre-tax income, operating cash flows being disposed versus remaining) and operating metrics, like total stores.

Example CO 2-3 illustrates the appropriate approach when a sale constitutes substantially all of a legal entity.

EXAMPLE CO 2-3

An acquisition of "substantially all" of a legal entity

Company A, an existing SEC registrant, owns and operates a national chain of convenience stores. Company A will acquire the shares of Acquiree B (a legal entity) in February 20x1 in a transaction that will be accounted for as an acquisition of a business in accordance with ASC 805, *Business Combinations*. Acquiree B owns and operates a national chain of 100 convenience stores. In January, prior to its acquisition by Company A, Acquiree B transfers 5 stores that are not being acquired by Company A to Acquiree B's shareholder. The 95 stores remaining in Acquiree B represent approximately 95% of the key operating assets of Acquiree B prior to its acquisition. The acquisition of Acquiree B and the remaining stores is significant to Company A and requires financial statements under Regulation S-X Rule 3-05.

How should the 5 stores not being acquired be reflected in Acquiree B's 20x0 financial statements?

Analysis

In preparing financial statements under Regulation S-X Rule 3-05, Company A would present separate financial statements of Acquiree B including all 100 stores in its Form 8-K because Company A has acquired "substantially all" of Acquiree B's key operating assets. The elimination of the remaining assets and liabilities not acquired (i.e., the 5 stores transferred prior to the acquisition by Company A) would be depicted in pro forma financial information in accordance with Regulation S-X Article 11.

Example CO 2-4 illustrates the determination of the appropriate approach when a sale does not constitute substantially all of a legal entity.

EXAMPLE CO 2-4

An acquisition of *"less than substantially all"* of a legal entity

Company A, an existing SEC registrant, owns and operates a national chain of convenience stores. Company A will acquire the shares of Acquiree B (a legal entity) in a transaction that will be accounted for as an acquisition of a business in accordance with ASC 805. Acquiree B owns and operates a national chain of 100 convenience stores. Prior to its acquisition by Company A, Acquiree B will transfer 60 stores that are not being acquired by Company A to Acquiree B's shareholder. The 40 stores remaining in Acquiree B represent approximately 40% of the key operating assets of Acquiree B prior to its acquisition. The acquisition of Acquiree B and the remaining stores is significant to Company A and requires financial statements under Regulation S-X Rule 3-05.

How should the 60 stores not being acquired be reflected in Acquiree B's financial statements?

Analysis

Given that the 60 stores not acquired by Company A represent significant operating assets retained by the seller, Company A would likely determine that the full financial statements of Acquiree B including all 100 stores would not be meaningful to the users of the financial statements. Rather, in preparing financial statements under Regulation S-X Rule 3-05, Company A would present carve-out financial statements for the 40 stores of Acquiree B. The footnotes to the financial statements should disclose that they represent the financial statements of the acquired component of Acquiree B (i.e., the 40 stores acquired). The financial statements would not represent that they consist of the consolidated financial statements of legal Acquiree B since the consolidated financial statements of legal Acquiree B would include all 100 stores.

2.2 Abbreviated financial statements

Regulation S-X Rule 3-05(e) permits a registrant to provide abbreviated financial statements for an acquired or to be acquired business that include a statement of assets acquired and liabilities assumed and a statement of comprehensive income that is modified to omit certain expenses such as corporate expenses if certain criteria are met. In addition, in certain circumstances, Regulation S-X Rule 3-05(f)(2) allows oil and gas companies to present a statement of revenues and expenses that excludes expenses not comparable to the proposed future operations, such as depreciation, depletion and amortization, corporate overhead, income taxes, and interest for debt that will not be assumed.

Refer to SEC 4550.32 and SEC 4550.6 for further guidance on the use of abbreviated financial statements and relevant considerations when a registrant does not meet the criteria set forth in S-X Rule 3-05(e) but believes abbreviated financial statements would provide sufficient disclosure for investors.

Chapter 3: Preparing carve-out financial statements—updated January 2024

3.1 Basis of presentation–overview

Once a reporting entity determines its filing requirements (see CO 1.2) and whether to apply the legal entity approach (see CO 2.1.1) or the management approach (see CO 2.1.2), it is necessary to determine the assets, liabilities, and operations that will be included in the carve-out financial statements.

The basis of presentation should be disclosed in the carve-out financial statements. The financial statements should be appropriately titled as either consolidated or combined in accordance with ASC 810-10-05, ASC 810-10-55-1B, and Regulation S-X Rule 3A-01 through Regulation S-X Rule 3A-04 (for filings with the SEC). When the financial statements constitute a legal entity that has a controlling financial interest in all other entities included in the financial statements, the statements are referred to as consolidated financial statements.

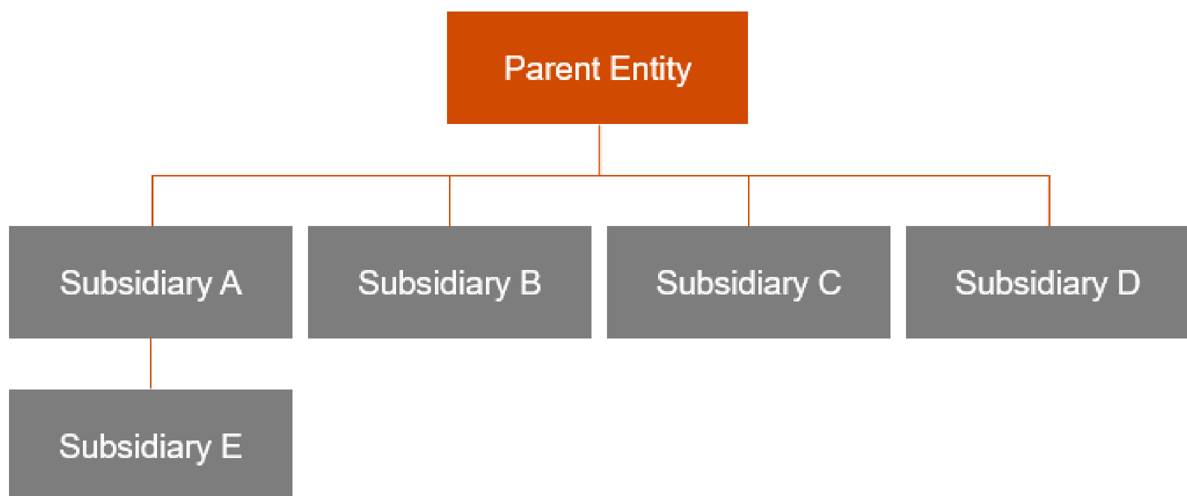
Conversely, in a situation when there are multiple legal entities included in the financial statements, but they are not under the control of a single legal entity that is part of the carve-out financial statements, the financial statements will be referred to as combined. Combined financial statements may also be presented when assets and operations that represent components of multiple legal entities are presented, such as when a set of carve-out financial statements is required for a collection of product lines that are not manufactured by the same division of an organization.

Example CO 3-1 illustrates how the structure of a transaction influences whether the financial statements are labeled as consolidated or combined.

EXAMPLE CO 3-1

Divestiture scenario that results in preparation of combined financial statements

Parent Entity plans to sell Subsidiary A, Subsidiary B, and Subsidiary E to a buyer.



Should the carve-out financial statements be labeled as consolidated or combined?

Analysis

The financial statements should be labeled as combined. Consolidated financial statements are prepared on the basis of a controlling financial interest. Neither Subsidiary A nor Subsidiary B have a controlling financial interest in each other. Subsidiary A and Subsidiary B are sister entities. Financial statements are only labeled as consolidated when there is a parent-subsidiary relationship for all entities included in the financial statements. Although Subsidiary A and Subsidiary E have a parent-subsidiary relationship, because Subsidiary B is a sister entity, the financial statements should be labeled as combined. Financial statements cannot be labeled as both consolidated and combined.

If prior to the sale, Parent Entity created a newco and contributed Subsidiary A, Subsidiary B, and Subsidiary E to the newco, this would be a transaction of entities under common control. If newco's financial statements include the period in which the newco was created, those financial statements would reflect the recapitalization retrospectively for all periods presented (i.e., as if the newco had always existed) and the financial statements would be labeled as consolidated.

3.2 Carve-out principles

The purpose of preparing carve-out financial statements is to present the historical financial position and results of operations for the carve-out business. Determining the assets, liabilities, revenues, and expenses reflected in the carve-out financial statements may require judgment and will be influenced by how the carve-out business is defined. See CO 4 for the factors to consider when attributing assets and liabilities. See CO 5 for the factors to consider when allocating expenses.

3.2.1 Assets and liabilities

Carve-out financial statements include assets and liabilities (or components of assets or liabilities) relating to the operations of the carve-out business. For example, a component of the parent entity's accounts receivable may be generated through the revenue-generating activities of the carve-out business and so are directly attributable to the carve-out business. As such, these receivables would be included on the carve-out balance sheet. Additional factors that may be considered when determining which assets and liabilities to attribute to the carve-out business include whether or not the asset or liability will be transferred in the transaction and which entity holds the legal title (asset) or has the legal obligation (liability).

In some instances, assets or liabilities are shared by the carve-out business and an affiliate of the parent entity, or with the parent itself (such as a corporate office building). It is typically not appropriate to partially allocate assets or liabilities. A determination will need to be made with regard to full attribution or exclusion of such items from the carve-out financial statements. Even if a specific asset or liability is excluded from the balance sheet, the carve-out business recognizes an appropriate allocation of the associated income statement impact. For example, a corporate office building may not be attributed to the carve-out balance sheet, but the carve-out entity would be allocated a portion of the depreciation expense. See CO 5.4.2.

3.2.2 Revenues and expenses

Revenues of the carve-out business are often easily identifiable, even at a level below a reportable segment or business unit. As a result, revenues will often be one of the more straightforward line items to assign to a carve-out entity.

With respect to costs, the historical income statements should reflect all of its costs of doing business, including costs incurred on the carve-out entity's behalf by its parent. One of the challenges when preparing carve-out financial statements is the allocation of indirect costs, such as corporate overhead. In SAB Topic 1.B.1, *Costs reflected in historical financial statements*, codified in ASC 220-10-S99-3, the SEC staff noted the expenses recorded in the historical carve-out financial statements should reflect a reasonable allocation of costs incurred by the parent entity on behalf of the carve-out business. See CO 5.2 for a discussion of this topic.

3.3 Use of hindsight when preparing financial statements

Generally, management should not use hindsight to prepare carve-out financial statements. Management should determine the information it believes was available at the time the historical financial statements of the parent entity were prepared. For example, a customer of the carve-out business may file for bankruptcy in a period subsequent to the filing of the parent entity financial statements. Management should generally not write-off receivables from this customer when preparing the carve-out financial statements for an earlier period, unless there was information available at the time of the preparation of the parent entity financial statements which would indicate such receivables were not collectible.

A similar approach is applied for legal contingencies that changed in subsequent periods. See Example FSP 28-2 for our view for recording a recognized subsequent event that arises for a subsidiary after its parent company's financial statements are issued.

If information obtained in preparing carve-out financial statements results in the identification of errors (i.e., information available at the time of the preparation of the parent entity financial statements that was not considered), consideration should be given to whether the carve-out financial statements should be adjusted. Consideration should also be given to the potential effect on the previously issued consolidated financial statements of the parent entity. See FSP 30.7 for more information on correction of errors.

3.4 Materiality, new accounting standards, and preferability

Generally, the accounting policies of the carve-out business should reflect the historical accounting policies applied by the parent entity. However, preparation of carve-out financial statements can result in adoption of an accounting principle or a change in accounting principle due to (1) materiality differences between the parent entity and the carve-out business, (2) newly issued accounting standards, and (3) preferability. See CO 3.4.1 through CO 3.4.3 for a discussion of these three topics.

ASC 250-10-45-1 through 250-10-45-2 provides guidance on these topics.

ASC 250-10-45-1

A presumption exists that an accounting principle once adopted shall not be changed in accounting for events and transactions of a similar type. Consistent use of the same accounting principle from one accounting period to another enhances the utility of financial statements for users by facilitating analysis and understanding of comparative accounting data. Neither of the following is considered to be a change in accounting principle:

a. Initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect

b. Adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.

ASC 250-10-45-2

A reporting entity shall change an accounting principle only if either of the following apply:

a. The change is required by a newly issued Codification update.

b. The entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable.

3.4.1 Materiality

Materiality for the carve-out business will frequently differ from that applied by the parent entity. As a result, management of the carve-out business may need to revisit accounting policies for items that were considered immaterial for purposes of the parent entity's consolidated financial statements.

The initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were deemed immaterial by the parent would not be considered changes in accounting principles.

3.4.2 New accounting standards

Many accounting standards have different adoption dates for public business entities and non-public business entities. To determine the applicable effective dates for the relevant accounting standards, management should consider the purpose of the financial statements (e.g., Regulation S-X Rule 3-05, Regulation S-X Rule 8-04, IPO), and to the extent applicable, the type of issuer the carve-out entity will be (e.g., smaller reporting company or emerging growth company).

Oftentimes the carve-out business adopts new accounting standards at the same time as the parent entity. However, there may be limited situations when the timing of adoption differs between the parent entity and the carve-out business. For example, if the parent entity is private but the carve-out financial statements will be used for an IPO, the carve-out may need to adopt standards in an earlier period. This can also depend on whether the carve-out entity meets the definition of an emerging growth company and the extended transition provisions are elected.

If the carve-out business is a private entity, it may elect the private company accounting alternatives.

3.4.3 Preferability

A carve-out business can adopt an accounting principle different from that used by its parent, provided that the change is preferable.

A change in accounting policy requires retrospective application. The reporting entity must disclose the nature of the change in accounting principle and explain why the newly adopted accounting principle is preferable.

Reporting entities sometimes sell or spin-off divisions or subsidiaries. A spin-off is a transaction in which a portion of a reporting entity (e.g., a division, a subsidiary) becomes a new, separate reporting entity and the shareholders of the original reporting entity receive a pro rata ownership in the spun-off reporting entity.

When a division or subsidiary is preparing its financial statements to facilitate a sale or spin-off, the division or subsidiary usually follows the accounting principles of its parent. When a division or subsidiary is spun-off, it can change to an accounting principle different from that used by its parent, provided that the change is preferable. Such a change in accounting principle should be applied retrospectively in the financial statements.

The spun-off reporting entity must disclose the nature of the change in accounting principle and explain why the newly-adopted accounting principle is preferable; however, a preferability letter will not be required when filing on Form 10.

A spun-off reporting entity cannot, however, retrospectively reflect changes in estimates. Such changes should be reflected in the period in which they occur in both the consolidated (if applicable) and spun-off reporting entity's financial statements.

3.5 Accounting policies in a common control transaction

When carve-out financial statements include entities under common control, a question arises related to conforming accounting policies.

Subsidiaries of a common parent generally have similar accounting policies; however, US GAAP does not require them to be the same. Therefore, in a common control transaction, the receiving entity and the transferring entity may have differing accounting policies. For instance, one entity may apply last-in, first-out for inventory while the other uses a different method for similar types of inventory. ASC 805-50-30-6 describes the accounting when this occurs.

ASC 805-50-30-6

In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method shall be applied retrospectively, and financial statements presented for prior periods shall be adjusted unless it is impracticable to do so. Section 250-10-45 provides guidance if retrospective application is impracticable.

If the receiving entity's method is not preferable, the receiving entity may account for the transferred assets and liabilities under the transferring entity's existing accounting method. Alternatively, if either the transferring entity or receiving entity were to change its accounting policy, it must be preferable.

For more on conforming accounting policies for entities under common control, see BCG 7.1.3.8.

3.6 Pushdown accounting

The carve-out financial statements may represent a business that was previously acquired by the parent in a business combination.

If stand-alone financial statements were previously prepared and pushdown accounting was not elected, the carve-out financial statements would not reflect the stepped-up basis. However, if the carve-out entity wants to elect pushdown, this is a change in accounting policy and a preferability assessment would be required to apply push-down accounting.

If stand-alone financial statements have not been historically prepared for the business being divested, management can elect to apply pushdown accounting without a preferability assessment.

As pushdown accounting is optional, one component of a carve-out entity could apply pushdown accounting while another component does not. For example, assume that carve-out financial statements are being prepared that combine Business A and Business B, both of which had previously been acquired by Parent. Business A had previously elected pushdown accounting but Business B did not. In this scenario, the combined financial statements of Business A and Business B would reflect a "mixed" basis as Business A would reflect the Parent's basis and Business B would reflect its historical basis. See BCG 10.1 for more information on pushdown accounting.

If, in connection with preparing the business to be divested, the parent entity transferred businesses or net assets between entities under common control, the transferred assets and liabilities will need to be reflected at the ultimate parent's basis whether or not pushdown accounting was elected in the previously prepared stand-alone financial statements.

For more on transfers between entities under common control, see BCG 7.1.3. For more guidance on determining the proper basis at which to record transfers of assets or the exchange of shares between entities under common control, see BCG 7.1.3.1.

Chapter 4: Balance sheet methodology—updated January 2024

4.1 Balance sheet methodology—overview

The carve-out entity should determine which assets and liabilities relate to the operations of the carve-out business by considering:

- the extent to which the asset was used in its operations or if the liability was created by the operations;
- whether the asset or liability will be transferred in the transaction; and
- which entity holds the legal title (asset) or has the legal obligation (liability).

Sometimes attributing the asset or liability to the carve-out business is straightforward. For example, a factory owned by the carve-out business and used to manufacture its product is directly attributable to the carve-out business and would be reflected on its balance sheet. Other times, however, the assets or liabilities are shared by the carve-out business and the parent or an affiliate of the parent (such as a corporate office). It is generally not appropriate to allocate assets or liabilities on a pro-rata basis. Assets and liabilities are fully attributed or fully excluded from the carve-out balance sheet. Even if a specific asset or liability is excluded from the balance sheet, the carve-out business may need to recognize an appropriate allocation of the associated income statement impact.

In certain situations, an asset or liability may need to be separated into individual units of accounts so that the parts can be attributed to the parent and carve-out. For example, accounts receivable that were generated through sales made by the carve-out business are directly attributable to the carve-out business, but often are commingled with the parent entity's accounts receivable and may need to be separated from the larger population of accounts receivable. The level of effort to evaluate and bifurcate commingled balances, especially on the balance sheet, can be challenging when preparing carve-out financial statements.

4.2 Balance sheet—assets

The carve-out balance sheet should include assets that relate to the operations of the carve-out business. In determining the assets to include, management should consider:

- the extent to which the asset was used by the carve-out business;
- whether the asset will be transferred in the transaction; and
- which entity holds the legal title, and whether that legal entity will be transferred in the transaction.

4.2.1 Cash and cash equivalents

When the carve-out entity includes legal entities that have legal ownership over bank accounts, the cash is included within the carve-out financial statements. See CO 4.5.1 for accounting for cash sweep accounts.

Whether or not the carve-out business has bank accounts, the statement of cash flows should reflect the inflows and outflows of cash during the period related to the activities of the carve-out business. See CO 6.4 for more on the statement of cash flows.

4.2.2 *Accounts receivable*

Accounts receivable are included in the carve-out balance sheet when they result from sales of products or services by the carve-out business. That is, a portion of the parent entity's accounts receivable and related allowance for doubtful accounts may be directly related to the carve-out business. However, it may not be straightforward to identify which portion of the accounts receivable relates to the carve-out business if the information is not readily available at the level at which the carve-out financial statements are being prepared. For example, it can be challenging when the customers of the carve-out business are the same as those of the businesses being retained by the parent entity. Management should develop a process to attribute the receivables to the carve-out business. For example, management may be able to identify SKUs or other carve-out-specific identifiers, such as product lines or product categories, to identify the transactions related to the carve-out business.

4.2.2.1 *Expected credit losses*

While ASC 326-20 does not apply to related party loans and receivables between entities under common control, if, as a result of the transaction structure, a carve-out entity and parent entity cease to be under common control and the entities continue to have loans and receivables, those arrangements will now be subject to ASC 326. Refer to the Loans & investments guide for further information on accounting for loans and receivables under ASC 326.

4.2.3 *Investments*

When the carve-out entity includes legal entities that have investments in debt or equity securities, those investments are included within the carve-out financial statements. Such legal entities may have independently elected to apply the fair value option in their own financial statements, regardless of the election made by the parent entity, as noted in ASC 825-10-25-6.

ASC 825-10-25-6

An acquirer, parent, or primary beneficiary decides whether to apply the fair value option to eligible items of an acquiree, subsidiary, or consolidated VIE, but that decision applies only in the consolidated financial statements. Fair value option choices made by an acquired entity, subsidiary, or VIE continue to apply in separate financial statements of those entities if they issue separate financial statements.

When the election of the carve-out business differs from the parent, the election of the carve-out entity should be used for purposes of the carve-out financials.

4.2.4 *Inventory*

Finished goods inventories are typically easily identified for purposes of preparing the carve-out financial statements. However, it can be challenging to identify raw materials or work in process that may have alternative uses (e.g., used in products sold by the carve-out business and other unrelated businesses of the parent). Therefore, attribution methods may need to be developed by management in order to identify the inventory recorded in the carve-out financial statements.

Another challenge can arise when management uses the last-in first-out (LIFO) method to account for inventory. In these situations, management may prepare a separate LIFO pool calculation for the carve-out business or it may use an attribution method.

Management also needs to identify any inventory reserves (e.g., lower-of-cost and net realizable value, reserves for excess and obsolete inventory) related to the carve-out entity's inventory.

4.2.5 Property, plant, and equipment

In certain situations, attribution of property, plant, and equipment is straightforward as the asset is used solely by the carve-out entity and the carve-out entity has title to the asset. Other times, long-lived assets are used by the parent (or other subsidiaries) and the carve-out business, such as a shared production line in a plant owned by the parent.

Long-lived assets are frequently shared resources. Generally the concept of "allocating" a percentage of an asset to the balance sheet would not be appropriate. The carve-out entity must determine whether it should recognize or exclude the entire asset based on the criteria described in CO 4.2. See CO 5.4 for a discussion on the expense allocation related to shared assets.

Example CO 4-1 provides an example of attribution of shared assets to a carve-out entity.

EXAMPLE CO 4-1

Shared assets attribution in carve out scenario

The carve-out business holds legal title to the equipment. Approximately 50% of the production capacity of the equipment is used to manufacture products for the carve-out business and the equipment will be part of the divestiture transaction. The other 50% of production capacity is used by the parent.

Should the carve-out balance sheet reflect this shared equipment?

Analysis

Yes. Although the equipment is used by the parent entity and the carve-out business, because the carve-out business holds legal title and the equipment will be transferred as part of the divestiture transaction, it would be appropriate to attribute the equipment to the carve-out business. While the income statement of the carve-out financial statements would reflect the depreciation of the equipment, that charge may be offset by a benefit for the usage by the parent as described in CO 5.4.2.

4.2.5.1 Property, plant, and equipment impairment

When testing for impairment, ASC 360, *Property, Plant, and Equipment,* requires assets to be grouped at the lowest level for which identifiable cash flows are largely independent of cash flows from other assets and liabilities. Management should determine the asset groups from the perspective of the carve-out business as they may be different than the parent entity's asset groups. For example, assume five production facilities were considered a single asset group by the parent entity because the cash flows from these facilities were highly interdependent. If the carve-out business only includes one of the five facilities, the asset group of the carve-out might be at the individual facility level.

Long-lived assets (asset groups) must be tested for recoverability whenever changes in circumstances indicate that the carrying amount may not be recoverable, as discussed in ASC 360-10-35-21. Accordingly, when asset groups in the carve-out financial statements differ from the parent entity's asset groups, management will need to evaluate whether the carrying amount of the asset groups are recoverable for all periods for which carve-out financial statements are being prepared, based on the carve-out asset grouping. In determining whether an impairment trigger existed in the historical periods, hindsight should not be used. That is, the assessment and related cash flows should be based on the information that existed at the time and should not reflect subsequent events.

Another difference that may exist between the parent entity and the carve-out entity is the accounting model used. Specifically, the parent may be required to apply the held-for-sale impairment model either in a sale transaction or contemporaneously with a spin-off. However the carve-out business would continue to apply the held-and-used model. Accordingly, it is possible that the parent entity could be required to record an impairment for assets that are not otherwise impaired at the carve-out level.

Example CO 4-2 illustrates a long-lived asset impairment analysis.

EXAMPLE CO 4-2

Long-lived asset impairment analysis

On August 31, Company P entered into an arrangement to sell Business C for $500. The carrying value of Business C in Company P's financial statements is $700. Assume for simplicity that there are no costs expected to be incurred to sell Business C. The decision by Company P to sell Business C meets the requirements for the disposal group to be evaluated for impairment under the held-for-sale model. If Business C were to review its long-lived assets for impairment under the held-and-used model, undiscounted cash flows would exceed the carrying value of the long-lived assets and, therefore, indicate that the carrying amount of the asset group is recoverable.

Should Company P and/or Business C record an impairment charge for the long-lived assets?

Analysis

An impairment charge of $200 should be recorded in the consolidated financial statements of Company P under the held-for-sale model. No impairment loss should be recorded in the carve-out financial statements of Business C because its long-lived assets are not impaired based on testing under the held-and-used model. That is, the $200 loss recorded by Company P should not be pushed down to Business B's financial statements.

4.2.6 Leases from the lessee's perspective—after adoption of ASC 842

If the carve-out business contains a legal entity, management should evaluate its contracts to determine if the contracts are or contain leases. The carve-out business will need to determine if it has a contract with the parent. ASC 606-10-25-2 provides the definition of a contract.

ASC 606-10-25-2

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

If the carve-out business has a contract with the parent, management should consider the flowchart depicted in ASC 842-10-55-1 to determine whether the contract is or contains a lease. If the contract contains a lease, the carve-out entity would reflect a ROU asset and ROU liability on its balance sheet.

If the parent is a lessee and the carve-out business determined that it did not have a lease with the parent, the ROU asset and liability would typically not be reflected in the carve-out financial statements. However, if the leased asset is used solely in the operations of the carve-out business and the lease will be assumed by the carve-out entity, management may determine that the economics of the transaction would be best captured by reflecting a ROU asset and ROU liability in the carve-out financial statements.

Regardless of whether an asset or a liability is recognized, if the leased asset is utilized in the operations of the carve-out business, the carve-out financial statements would include an allocation of expense from the parent entity. See CO 5.2 for a discussion of the income statement allocation.

4.2.7 Goodwill

Goodwill may need to be reflected in the carve-out financial statements. In making this determination, management should consider whether the assets and liabilities of the carve-out business will be reflected at the ultimate parent's basis. See CO 3.6 for a discussion on when the assets and liabilities of the carve-out business should be reflected at the ultimate parent's basis.

4.2.7.1 Attribution of goodwill

If the carve-out financial statements reflect the parent's basis, the financial statements would usually include the historical goodwill amount. That is, acquisition-specific goodwill recognized by the parent that directly relates to the carve-out business would be presented in the carve-out financial statements.

Conceptually, goodwill should be attributed to the carve-out entity based on the amount that would have been recognized when it was acquired, as discussed in ASC 350-20-35-42. That means that management would need to consider the fair value of the carve-out business and its assets and liabilities at the date of original acquisition. The amount of the goodwill recognized in the carve-out financial statements may not be the same as the amount of goodwill assigned by the parent to the divested business. See BCG 9.10.5 for more information on accounting by the parent entity.

When it is impracticable to determine what the fair value of the carve-out business and its assets and liabilities were at the date of original acquisition, management should develop a reasonable and supportable methodology for determining the goodwill attributable to the carve-out business and apply the methodology consistently for all periods presented. For example, an approach may include

attribution based on the proportionate fair value of the acquired business included in the carve-out business relative to the fair value of the acquired business as a whole on the date of acquisition.

Attribution of goodwill may be complex when the carve-out business was acquired as part of a larger acquisition and may be even more so if the carve-out includes components of multiple acquisitions. For example, if the carve-out business represents one out of three businesses acquired in a single transaction, and the entire transaction was assigned to a single reporting unit at the parent level, management would need to determine what portion of the goodwill resulting from the acquisition should be attributed to the carve-out business.

In some cases, goodwill may have lost its identity subsequent to acquisition due to reorganizations of the business (including changes in segments or reporting units), or the valuation performed at the time of the original acquisition may not have included information at a level of detail sufficient to determine the relative fair values as of that date. In such cases, another reasonable methodology may be utilized to determine the amount of goodwill to attribute to the carve-out business.

Example CO 4-3 provides an example of initial recognition of goodwill in carve-out financial statements, and Example CO 4-4 provides an example of the allocation of goodwill to reporting units in carve-out financial statements.

EXAMPLE CO 4-3

Historical goodwill presentation

On March 1, 20X3, Company A acquired Business B for $500 million. The fair value of the identifiable net assets acquired was $360 million and goodwill was $140 million. Business B is included in Company A's reporting unit RU2. RU2 also includes the net assets ($200 million) and goodwill ($30 million) of Business C, which was acquired by Company A on March 1, 20X1.

On March 1, 20X6, Company A decides to spin off Business B and will retain the remaining assets in RU2 attributable to Business C. What is the amount of goodwill that should be included in the carve-out financial statements?

Analysis

Acquisition-specific goodwill related to Company A's acquisition of Business B of $140 million would be included in the carve-out financial statements. This is because that historical goodwill is identifiable and relates specifically to the carve-out business.

EXAMPLE CO 4-4

Allocation of goodwill to reporting units

On March 1, 20X1, Company A acquires Entity C, which is comprised of two businesses, for $300 million and records $140 million of goodwill. On the acquisition date, one of the businesses (Business B) had a fair value of $150 million with identifiable net tangible and intangible assets comprising $60 million of that amount.

On March 1, 20X4, Company A decides to spin off Business B and prepares carve-out financial statements. What is the amount of goodwill that should be included in the carve-out financial statements?

Analysis

In order to determine the amount of goodwill to attribute to the carve-out financial statements, management would first consider the fair value of the business being sold on the date it was acquired. This value would be the basis for deriving the carve-out goodwill following the guidance in ASC 350-20-35-42. As a result, the acquisition-specific goodwill attributed to the carve-out business is $90 million, or the difference between Business B's $150 million fair value and $60 million net assets based on the information that was available on the acquisition date.

If this method is impracticable because Company A did not perform a separate analysis of identifiable net assets of the two business on the acquisition date, Company A may consider an approach that compares the fair value as of the acquisition date (i.e., March 1, 20X1) of the business to be sold ($150) to Entity C ($300). Given the carve-out business represented 50% of the acquisition date fair value, $70 million of acquisition-specific goodwill (50% of the $140 million goodwill balance) would be attributed to the carve-out business.

In instances when the attribution of goodwill to the carve-out business represents only a portion of a parent entity's reporting unit and an impairment charge was recorded prior to the opening balance sheet date presented in the carve-out financial statements, management should consider what portion, if any, to attribute to the carve-out business. ASC 350-20-40, which provides guidance on accounting for the disposal of all or a portion of a reporting unit, may be helpful to consider in these situations.

4.2.7.2 *Private company accounting alternatives*

There may be instances when the carve-out entity is a private entity that has elected to adopt the private company accounting alternatives, which include but are not limited to:

- electing to amortize goodwill, and
- not recognizing noncompetition agreements and customer-related intangibles in an acquisition (unless they are capable of being sold or licensed independent from the other assets of the acquired business).

Accordingly, the goodwill balance in the carve-out entity may differ from that shown by the parent.

If the carve-out business elects not to recognize noncompetition agreements and customer-related intangibles, it must also elect to amortize goodwill.

Private company accounting alternatives cannot be used in financial statements that will be included in an SEC filing. See BCG 9.11 for further discussion of the goodwill alternative for private companies/NFP entities. See BCG 4.7 for further discussion of the intangible assets alternative for private companies/NFP entities.

4.2.7.3 *Goodwill impairment*

Goodwill attributed to the carve-out financial statements should be tested for impairment as if the carve-out entity was a standalone entity, as described in ASC 350-20-35-48. As a result, the carve-out business will need to determine its chief operating decision maker (CODM) to determine its operating segments and reporting units. The reporting units may be different from those of the parent entity. See

FSP 25 for further details regarding the identification of operating segments and information related to the CODM.

Once the reporting units of the carve-out business and the amount of goodwill attributable to each reporting unit(s) have been determined, management should assess goodwill for impairment as of the first day of the initial year presented in the carve-out financial statements (i.e., the opening balance sheet date), and at least annually thereafter, based on the reporting units of the carve-out business. Impairment tests performed for the carve-out business may result in impairment charges that were not previously recognized by the parent entity.

4.2.8 Intangible assets

Similar to goodwill (discussed in CO 4.2.7), intangible assets recorded in prior acquisitions may need to be reflected in the carve-out financial statements. It may be difficult to determine whether to attribute the intangible assets to the carve-out business if the assets are shared between the carve-out business and other affiliated entities of the parent. See CO 4.2 for the factors to consider when determining whether to attribute intangible assets to the carve-out entity.

Management should consider whether the assets and liabilities of the carve-out business will be reflected at the ultimate parent's basis. See CO 3.6 for the discussion on when the assets and liabilities of the carve-out business should be reflected at the ultimate parent's basis.

4.2.8.1 Finite-lived intangible assets

If the carve-out business reflects a finite-lived intangible asset on its balance sheet based on the criteria described in CO 4.2, the corresponding amortization expense is also recognized. However, when the carve-out business does not reflect the carrying amount of the finite-lived intangible asset, management should calculate a charge for its use of the intangible as described in CO 5.4.2.

Example CO 4-5 and Example CO 4-6 provide examples of the initial recognition of a finite-lived intangible asset in carve-out financial statements.

EXAMPLE CO 4-5

Intangible asset - finite-lived asset

The carve-out business and several other business units use the parent entity's brand name, which is legally owned by the parent entity. The rights to the brand name will not be sold as part of the divestiture. The brand name is a finite-lived intangible asset (i.e., it was not internally developed).

Should the brand name intangible asset be included in the carve-out financial statements?

Analysis

No. Because the brand name is legally owned by the parent entity, will not be sold as part of the transaction, and is not solely utilized in the operations of the carve-out business, it would not be attributed to the carve-out business. The carve-out income statement would, however, reflect an allocation of the parent entity's amortization expense, as discussed in CO 5.4.2.

EXAMPLE CO 4-6

Intangible asset - finite-lived asset

The carve-out business is the exclusive user of a patent that is legally owned by the parent entity. The rights to the patent will be sold as part of the divestiture. The patent is a finite-lived intangible asset (i.e., it was not internally developed).

Should the patent be included in the carve-out financial statements?

Analysis

Yes. Because the patent will be sold as part of the divestiture and the patent was used exclusively by the carve-out business, it would be appropriate to attribute the patent to the carve-out business. Because the patent is solely used by the carve-out business, the carve-out income statement would reflect the full cost of amortization of the patent, as described in CO 5.4.2.

Finite-lived intangible asset impairment

Finite-lived intangible assets are tested for impairment under ASC 360 whenever changes in circumstances indicate that the carrying amount may not be recoverable. See CO 4.2.5.1.

4.2.8.2 Indefinite-lived intangible assets

If the carve-out business and the parent use the indefinite-lived intangible asset, then management needs to determine whether it should reflect the indefinite-lived intangible asset in the carve-out financial statements based on the criteria described in CO 4.2.

Indefinite-lived intangible asset impairment

When indefinite-lived intangible assets are recorded in the carve-out financial statements, management must determine the unit of account for purposes of impairment testing in accordance with ASC 350-30-35-21 through ASC 350-30-35-28. In some instances, indefinite-lived intangibles may be operated as a single asset (i.e., they are inseparable from one another) and are combined into a single unit of account for impairment testing. See BCG 8.3.2.1 for more on the unit of account for indefinite-lived intangibles.

Indefinite-lived intangible assets are assessed for impairment at least annually and when triggering events have occurred during the period. If the unit of account and the basis of accounting of the parent and carve-out entity business are consistent, the assessments performed in support of the carrying value of the indefinite-lived intangible assets for the parent entity could be used to support management's impairment assessment for the assets attributable to the carve-out business. When the unit of account of the carve-out business differs from that of the parent entity, or when the assets reflected in the carve-out financial statements are not recorded at the ultimate parent's basis, management must assess the indefinite-lived intangible assets for impairment as of the opening balance sheet date and for each of the subsequent years included in the carve-out financial statements. This should be performed without the benefit of hindsight.

4.3 Balance sheet—liabilities

Some of the considerations that may be needed to be applied when preparing the liability portion of the balance sheet for the carve-out entity are discussed in CO 4.3.1 through CO 4.3.5. In making the determination of which liabilities to include, reporting entities should consider:

- the extent to which the liability was created by the carve-outs operations,
- whether or not the liability will be transferred in the transaction, and
- which entity has the legal obligation (liability).

4.3.1 Accounts payable and accrued expenses

Accounts payable are attributed to the carve-out financial statements when the accounts payable balance relates to an underlying expenditure associated with the historical operations of the carve-out business.

Accounts payable are often subject to centralized processing or are commingled with payables related to other affiliated entities. Therefore, it may be challenging to separate the underlying accounts payable balances to identify those attributable to the carve-out business. In such situations, management may utilize attributes of the accounts payable to determine whether they are related to the carve-out business. For example, inventory-related purchases may be separated from other accounts payable balances and management may determine if they relate to the historical operations of the carve-out business based on the materials included on the invoice. In cases when the type of inventory relates both to the carve-out business and an affiliated entity, management may need to further analyze the purchases based on additional factors, such as the location where the materials were shipped.

4.3.2 Contingent liabilities

Contingent liabilities may arise due to litigation or environmental matters. Though the contingent liabilities and related expenses may be specific to certain entities, they are often recorded at the parent level. As such, it is important for management to assess each contingency to determine if it is appropriate to attribute the liability to the carve-out business.

Factors in this analysis are (1) whether the contingency directly relates to the historical operations of the carve-out business and (2) whether the carve-out business is the primary obligor or an indemnification exists between the carve-out business and parent entity.

In some cases, it may be difficult to determine whether the contingency relates to the carve-out business. For example, it may be difficult to determine attribution of a liability when claims resulted from injuries caused by a product defect and the product was sold by both the parent and the carve-out business. Determining the extent of liability between the parent and the carve-out business from years of product sales may involve significant judgment. If the parent entity is expected to settle the obligation (i.e., is the primary obligor), management would likely conclude that the related liability is not attributed to the carve-out financial statements.

Alternatively, if the carve-out business contractually agreed to indemnify the parent entity, an indemnification liability would be reflected in the carve-out financial statements. Regardless of

whether the liability is attributed to the carve-out financial statements, a reasonable portion of the related expense would be allocated to the carve-out financial statements as the carve-out business sold the products.

Additionally, the parent entity may indemnify the carve-out business for contingencies as part of the divestiture. If the exposure is directly attributable to the carve-out business' historical operations, the carve-out business would generally recognize a liability and expense in the carve-out financial statements, even though it is indemnified by the parent entity. Separately, the carve-out business would recognize a receivable (and an equity contribution from the parent) for the indemnity provided by the parent entity for periods in which the indemnity is in place.

Contingencies related to the carve-out business that are either (1) reasonably possible or (2) probable but not estimable require disclosure in the carve-out financial statements.

4.3.3 Contract liabilities (i.e., deferred revenue)

Contract liabilities (i.e., deferred revenue) are attributed to the carve-out financial statements when the carve-out business has a performance obligation to transfer goods or services to a customer and consideration has been received from the customer. The contract liability is recorded regardless of whether the cash received in advance of transferring the goods or services has been recorded in the carve-out financial statements.

4.3.4 Debt

Third-party debt issued by the carve-out business would be reflected in the carve-out financial statements. Any transaction costs and interest associated with the debt should also be reflected. Generally, the debt of the parent entity is not reflected in the carve-out financial statements based on an analogy to ASC 805-50-30-12.

ASC 805-50-30-12

An acquiree shall recognize in its separate financial statements any acquisition-related liability incurred by the acquirer only if the liability represents an obligation of the acquiree in accordance with other applicable Topics.

Debt may need to be reflected in the carve-out financial statements when the carve-out entity is jointly and severally liable or guarantees the debt. If the carve-out entity guarantees the debt, the guarantee should be recorded in accordance with ASC 460, *Guarantees*. See FG 2.6 for recognition and measurement of guarantees.

If the carve-out entity is jointly and severally liable with the parent, a reporting entity should consider the guidance in ASC 405-40-30-1, *Obligations Resulting from Joint and Several Liability Arrangements,* which states the following:

ASC 405-40-30-1

Obligations resulting from joint and several liability arrangements included in the scope of this Subtopic initially shall be measured as the sum of the following:

a. The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors.

b. Any additional amount the reporting entity expects to pay on behalf of its co-obligors. If some amount within a range of the additional amount the reporting entity expects to pay is a better estimate than any other amount within the range, that amount shall be the additional amount included in the measurement of the obligation. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range shall be the additional amount included in the measurement of the obligation.

As indicated in paragraph BC10 in the Basis for Conclusions of ASU 2013-14, *Liabilities (Topic 405), Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date*, the Task Force rejected the notion that a reporting entity would measure the obligation for which it is jointly and severally liable with the primary borrower as the total amount of the obligation. Rather, it should determine whether an agreement exists among its co-obligors which details the amount the reporting entity agreed to pay and record that amount (if such arrangement exists) and the reporting entity's best estimate of the amount it expects to pay on behalf of its co-obligors. Refer to FG 2.9 for further guidance on accounting for joint and several obligations.

4.3.5 Pensions

If the carve-out entity is the sponsor of a pension plan, the accounting would follow ASC 715, Compensation–Retirement Benefits, and the plan assets and liabilities would be reflected in the carve-out balance sheet.

ASC 715-30-55-63 through ASC 715-30-55-64 indicate that the separate financial statements of a subsidiary that participates in the parent's pension plan should reflect pension expense on a multiemployer basis. However, oftentimes carve-out financial statements are not comprised of legal subsidiaries but rather include divisions or businesses. Since carve-out financial statements may not technically be separate financial statements of a subsidiary, there is diversity in practice for the accounting for pensions in carve-out financial reporting.

The multiemployer guidance differs significantly from the "single employer" accounting guidance in ASC 715. Under multiemployer accounting, the carve-out business would only recognize a liability to the extent that the required contribution had not been paid at the end of the period. The assets of the plan would not be recorded in the carve-out financial statements.

Alternatively, an entity could choose to prepare the carve-out statements using a multiple-employer approach, essentially resulting in a single employer basis of accounting in the carve-out statements. Under this approach, reasonable allocations of the projected benefit obligation and plan assets of the parent plan would need to be made in order to reflect the carve-out entity's share as if it were the plan sponsor. However, use of the multiple-employer approach is not common in practice.

4.4 Equity

Amounts included in equity for the carve-out financial statements are driven by the structure of the carve-out business. Often, the traditional captions in equity (e.g., common stock, additional paid-in capital, retained earnings) are not relevant. This is because, in many cases, the carve-out business

represents only a portion of a legal entity (e.g., the carve-out of a product line), or a combination of legal entities or portions thereof. Therefore, it is common for components of equity other than accumulated other comprehensive income (loss) to be comprised of a single line item, often called "net parent investment" or "divisional equity." Alternatively, in instances when the carve-out business is a separate legal entity, and financial statements of the legal entity are prepared, the full historical equity structure of the legal entity will be presented in the carve-out financial statements.

The statement of changes in net parent investment or divisional equity will be limited to changes in the parent's net investment, accumulated other comprehensive income, and noncontrolling interests (if applicable).

In preparing the carve-out financial statements, the activity within the net parent investment account in the statement of changes in equity should be reconcilable to the other financial statements (e.g., income statement, statement of cash flows).

4.4.1 Net parent investment

The net parent investment consists of: (1) financing the carve-out business received from the parent entity to fund its operations through contributions to the carve-out business that did not require repayments, (2) cash dividends to the parent, (3) the net effect of cost allocations from transactions with the parent entity, from the carve out entity to its parent, and (4) the carve-out business' accumulated earnings. Some transactions can be specifically identified as divisional equity. For example, cash contributions from the parent or cash dividends to the parent. Other activity that is reflected represents the net settlement of intercompany transactions with the parent often related to working capital items.

The carve-out income statement reflects allocations of costs for items such as officer's salaries and rent expense, which may not have historically been charged to the carve-out entity. In order to record the cost allocation, a corresponding entry is made to the net parent investment account, to the extent such amounts are expected to be settled through an equity contribution rather than cash paid by the carve-out entity to the parent.

SAB Topic 1.B.1 Question 4 (codified in ASC 220-10-S99-3), indicates that for each period for which an income statement is presented, a reporting entity should include an analysis of the intercompany accounts and the average balance of the due to/due from parent. In practice, this analysis may take the form of listing the major components of the net parent investment (e.g., allocation of corporate costs, cash pooling or central cash management arrangements, financing activities).

4.4.2 Accumulated other comprehensive income (AOCI)

Carve-out financial statements should include the caption AOCI separate from divisional equity or net parent investment.

4.4.2.1 Cumulative translation adjustments

If the carve-out business consolidates a foreign entity, the carve-out business applies the guidance in ASC 830, *Foreign Currency Matters*, to determine the appropriate cumulative translation adjustments (CTA).

4.4.2.2 *Pension plan gain or losses*

If the multiemployer method is used to account for pensions, the plan assets and plan obligations are not recorded in the carve-out financial statements. Therefore, AOCI related to the pension plan(s) should not be recorded in the carve-out financial statements. However, if the carve-out entity has its own pension plan, applicable amounts should be reflected in AOCI.

4.4.2.3 *Unrealized gains and losses from hedging and AFS debt securities*

If a derivative instrument was recorded in the carve-out financial statements, then the changes in the fair value of the derivative instrument previously recognized in the parent entity's AOCI would be included in the carve-out financial statements. This also applies to AFS debt securities that have been attributed to the carve-out business.

Example CO 4-7 illustrates the recording of the various components of AOCI in carve-out financial statements.

EXAMPLE CO 4-7

Recording AOCI components in carve-out financial statements

Parent Entity plans to spin-off Subsidiary A. Prior to the spin, the consolidated financial statements of Parent Entity contain AOCI balances related to both Parent Entity and Subsidiary A's assets and liabilities. Specifically, the consolidated AOCI balance includes unrealized gains and losses on available-for-sale debt securities, unamortized gain/loss or prior service cost on subsidiary-specific pension plans, and cumulative translation adjustments.

How would AOCI attributable to assets and liabilities of Subsidiary A be presented in post-spin financial statements of Subsidiary A?

Analysis

AOCI related to Subsidiary A's assets and liabilities existing at the date of the spin should be maintained in the opening equity accounts of the post-spin entity. That is, AOCI should not be collapsed into APIC. See Example CO 6-1.

4.5 *Intercompany transactions*

Historical intercompany transactions and account balances of the carve-out business and parent must be identified and evaluated for proper presentation within the carve-out financial statements. Examples of intercompany transactions may include the following:

- Centralized cash management functions
- Intercompany amounts (including intercompany debt, payables, and receivables) as well as amounts previously recorded as "due to" or "due from" affiliates
- Inventory purchased by the carve-out business from affiliated entities, or vice versa
- Dividends between the carve-out business and parent

- Leases with the parent or other subsidiaries

Transactions that were historically eliminated in the consolidation of the parent entity's financial statements now represent transactions with related parties. These related party transactions require separate disclosure. See CO 6.2.3 for further discussion of related party disclosures.

In other cases, intercompany transactions not previously recorded between the carve-out business and parent company will need to be recognized in the carve-out financial statements.

Intercompany transactions and balances between entities within the carve-out business will continue to be eliminated in preparing the carve-out financial statements.

4.5.1 Centralized cash management functions

It is common for the carve-out business to participate in a centralized cash management arrangement. In these situations, on a periodic basis, excess cash balances or deposits are swept into a cash pool (i.e., sweep account) and mixed with cash from other affiliated entities. Generally, under these types of arrangements, the sweep accounts are legally held by the parent entity and are used to fund the cash requirements of the affiliated entities included within the arrangement. As the sweep accounts are legally held by the parent entity, it typically would not be appropriate to include the sweep account cash balances in the carve-out financial statements. Any balance not swept to the cash pool account would be included in the carve-out financial statements to the extent the balance remains in an account in the legal name of the carve-out business.

Deposits within centralized cash management arrangements represent amounts due from the parent entity to the carve-out business and are typically classified as such. It would not be appropriate to classify these as cash and cash equivalents, despite the fact they may be payable by the affiliated entity immediately or within three months of the balance sheet date.

4.5.2 Intercompany notes, debt, receivables, and payables

Intercompany notes and debt are generally presented as assets or liabilities (i.e., not collapsed into equity) when supported by a written agreement that includes principal amounts, interest rate, maturity date, etc.

When determining the classification of intercompany balances related to foreign entities, it may be helpful to understand prior assertions made by the parent entity. To account for the translation on intercompany loans, the parent would need to determine whether such loans were of a "long-term-investment nature" as described in ASC 830-20-35-3b. Foreign currency transaction gains and losses related to intercompany loans or advances that the parent asserts will not be settled in the foreseeable future are accounted for in the cumulative translation adjustments account upon consolidation (i.e., the gains and losses are not recorded in the income statement). See FX 7.5 for more on intercompany loans. This accounting is because an intercompany loan, while considered a long-term investment, is essentially a capital contribution. Any repayment of the loan would then essentially be a dividend.

The parent's stated intentions used to determine the appropriate tax treatment may also be informative. For example, the parent may have asserted that an intercompany loan will be repaid for tax purposes. This assertion may inform the classification of the intercompany agreement in the carve-out financial statements.

When not supported by written agreements, intercompany receivables and payables are reflected in the carve-out financial statements depending on the manner in which they will be settled. Intercompany balances expected to be settled between the carve-out business and retained entities of the parent (typically in cash) are reflected as "due to" or "due from" the parent entity in the carve-out financial statements. Conversely, if the intercompany balance is expected to be forgiven, it is reflected as an equity transaction (i.e., as a contribution or distribution of capital), which is included within the net parent investment account. If there is uncertainty as to how the transaction is to be settled, it may be appropriate to consider the past practices of settling intercompany funding provided by the parent entity.

4.6 Income taxes

Deferred tax assets and deferred tax liabilities will result from differences between the tax basis of an asset or liability and its reported amount in the carve-out financial statements. This will depend on which assets and liabilities have been attributed to the carve-out financial statements and the preparation of the tax provision, which is discussed in CO 5.8. Unless the carve-out entity is a tax paying entity, an income tax receivable/payable to the government is typically not reflected in the carve-out balance sheet because the carve-out entity is not the legal obligor.

See TX 14.8 for a discussion of how to prepare the carve-out tax provision and how to account for intercompany tax sharing arrangements.

4.7 Derivatives and hedging

Derivative instruments should be evaluated to determine if inclusion in the carve-out financial statements is appropriate. Generally, derivative contracts issued directly by the carve-out business are included in the carve-out financial statements. For some companies, the treasury function is managed centrally, and therefore, an evaluation would be performed to determine whether any parent entity derivative instruments should be recorded in the carve-out financial statements.

Derivative instruments issued by the parent entity designated as a hedging instrument of a hedged item that has been attributed to the carve-out financial statements should be included in the carve-out financial statements (e.g., an interest rate swap entered into by the parent on debt recorded in the carve-out financial statements). Any changes in the fair value of the derivative instrument previously recognized in the parent entity's AOCI for cash flow hedges would be included in the carve-out financial statements. Similarly, for fair value hedges, the carve-out financial statements would include the applicable portion of any basis adjustments made to a hedged item.

For derivative instruments issued by the parent entity meant to economically hedge transactions recorded in the carve-out financial statements that have not been designated as hedges for accounting purposes (and the derivative has not been recorded in the carve-out financial statements), the carve-out business may elect to either record or exclude the income statement effect of the derivative instrument in its financial statements. In either case, the methodology should be followed consistently with appropriate disclosure.

In some circumstances, a parent entity may enter into a derivative instrument that relates to both transactions recorded in the carve-out financial statements and transactions related to operations not part of the carve-out business. In these circumstances, it is not necessary to attribute a derivative asset/liability to the balance sheet in the carve-out financial statements; however, companies should consider whether allocations to the income statement provide the most relevant view of the historical operations for the carve-out business.

Chapter 5: methodology– updated April 2024

5.1 Income statement methodology–overview

The carve-out income statement should include revenues and expenses relating to the operations of the carve-out business. Reporting entities are required to include:

- revenues or expenses that are directly attributable to the carve-out business,
- the expenses related to assets and liabilities shared between the carve-out business and the parent, and
- any additional costs of doing business (i.e., an allocation of corporate costs).

5.2 Allocation of shared costs

The carve-out income statement should present all historical results of operations for the carve-out business, including costs incurred on its behalf. As the carve-out business represents a portion of the parent entity, certain of the costs of the parent entity are recorded by the carve-out business through cost allocation adjustments. SAB Topic 1.B, *Allocation Of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity* (codified in ASC 220-10-S99-3), addresses how to reflect all the costs of doing business in the financial statements.

Excerpt from ASC 220-10-S99-3

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. The subsidiary files a registration statement under the Securities Act of 1933 in connection with an initial public offering.

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.

Expenses that are not directly attributable to the carve-out business should be allocated using a reasonable method based on the guidance provided by the SEC staff in SAB Topic 1.B.1 Question 2 (codified as ASC 220-10-S99).

Excerpt from ASC 220-10-S99-3

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.

If the specific identification of expenses is not practicable, a reasonable method of allocating expenses to the carve-out business (e.g., incremental or proportional cost allocation) is used. Because the parent costs allocated to the carve-out business are related party transactions, management should include appropriate disclosures.

Figure CO 5-1 may be helpful in identifying a method for the reasonable allocation of corporate or other shared expenses. As the guidance is not prescriptive, other methods of allocation may be used if reasonable.

Figure CO 5-1
Potential allocation methods for shared costs

Shared cost type	Potential allocation method
Executive compensation	Percentage of sales/operating income
Employee compensation	Percentage of time spent/headcount
Rent or depreciation	Relative square footage/percentage of usage

Shared cost type	Potential allocation method
Advertising	Percentage of sales
Accounting and legal services	Percentage of sales/relative services rendered

Question CO 5-1 addresses how to allocate executive compensation to the carve-out business.

Question CO 5-1

A purchasing manager at a company historically spent 40% of her time on activities related to the carve-out business.

How should her salary be reflected in the carve-out financial statements?

PwC response

The company may determine it is appropriate to allocate 40% of the purchasing manager's salary and related benefits to the carve-out business. The intent of this allocation is to fully burden the carve-out business with the costs that were actually incurred by the parent on its behalf. The allocated costs may not be reflective of the actual costs expected to be incurred by the carve-out business as an unaffiliated entity with its own procurement team.

5.3 Revenue and cost of sales

The carve-out financial statements should reflect the revenue and cost of sales related to the products or service sold by the historical operations of the carve-out business.

5.4 Usage of long-lived assets by the carve-out business

The allocation of an expense associated with a long-lived asset to the carve-out business will depend on:

- whether the asset has a finite life or an indefinite-life, and
- the proportional usage of the asset between the carve-out business and the parent.

There can be situations when an asset has not been reflected on the carve-out balance sheet, but an expense needs to be recorded related to the use of that asset. Conversely, there can be situations when an asset has been reflected on the carve-out balance sheet, but an expense is offset by an imputed charge to the parent to reflect the cost of its proportional usage.

5.4.1 Shared indefinite-lived intangible assets

If the carve-out business does not reflect an indefinite-lived intangible asset on its balance sheet but benefits from use of the intangible asset, a question arises as to whether the carve-out business should record an expense. We believe that if the carve-out entity has not historically been charged for use of the parent's indefinite-lived intangible asset, an expense would not be reflected in the carve-out

financial statements because the parent is not amortizing the asset and therefore there is no cost to allocate.

5.4.2 *Shared long-lived tangible and finite-lived intangible assets*

In a divestiture, there may be instances when a long-lived asset was partially used by the carve-out business; however, that long-lived tangible asset was used more by the parent entity or is not being transferred in the transaction and has not been recorded in the carve-out financial statements. To the extent a carve-out business uses a portion of a long-lived asset that is recognized by the parent, expense would be recorded in the carve-out financial statements based on a systematic and rational allocation (e.g., proportional usage).

When the long-lived asset is reflected on the balance sheet, the depreciation expense associated with the asset is also recognized. If the parent entity uses a portion of the long-lived asset recognized by the carve-out business, depreciation expense is generally offset by an imputed charge to the parent to reflect the cost of its proportional usage. Generally, this imputed charge to the parent is recorded within other income, provided that the carve-out business does not regularly license or lease out this asset in their normal business operations.

5.5 *Employee compensation*

Employee compensation includes salaries, bonuses, deferred compensation, fringe benefits, and share-based awards. The carve-out financial statements should reflect an expense related to employees who provided services to the carve-out business. This includes direct employees of the carve-out business (specific identification) as well as allocations of costs that were incurred related to shared employees (i.e., corporate employee costs for individuals overseeing multiple business units of the parent).

5.5.1 *Cash compensation*

The allocation of shared costs concepts discussed in CO 5.2 applies to cash compensation expense. An allocation of cash compensation expense may be based on the percentage of time that an employee spends providing services to the carve-out business, or other reasonable metrics if a time-based allocation driver is not practicable.

5.5.2 *Share-based compensation*

Carve-out financial statements include the share-based payment expense related to awards held by employees who historically provided services to the carve-out business. If a share-based compensation plan is directly related to the carve-out business (e.g., the carve-out business is a separate legal entity or entities with its own share-based compensation plan), the share-based compensation expense is included in the carve-out financial statements. Otherwise, the cost is reflected in the carve-out income statement through an allocation from the parent entity. To the extent an allocation is required, the assumptions made to allocate share-based compensation are generally consistent with the assumptions and methodologies utilized for other cash-based compensation amounts.

For a carve-out of a separate legal entity with its own share-based compensation plan, ASC 718, *Compensation–stock compensation,* disclosures are included in the carve-out financial statements for the plan. When employees of the carve-out business participate in a parent's share-based payment plan, the carve-out financial statements should include relevant disclosures required by ASC 718;

however, these disclosures would likely be based on the parent's consolidated disclosures modified to reflect the balances related to employees of the carve-out business. For employees who provide service indirectly to the carve-out business (e.g., parent entity executive employees), the allocation of share-based compensation expense may be included in the disclosure of allocations of shared corporate costs.

5.5.2.1 Modifications to awards

In connection with a divestiture transaction, there may be modifications made to share-based payment awards (e.g., acceleration of vesting). These modifications are accounted for in accordance with ASC 718 and may result in additional compensation expense in the carve-out financial statements. See SC 4.5.4 for additional information on modifications to awards in connection with divestiture transactions.

5.5.3 Net periodic pension cost

As noted in CO 4.3.5, if the carve-out entity participates in the parent's pension plan then it can elect to apply the multiemployer approach or the multiple-employer approach. In practice, the multiemployer approach is more common than the multiple-employer approach. For the multiemployer approach, an expense should be recognized in the carve-out financial statements based on the required "contribution" to the plan for the period. Although the carve-out business may not have been historically required to make actual cash contributions, the amount recognized as expense represents an allocation of net periodic pension cost, which must include (at a minimum) service cost.

For the multiple-employer approach, an expense should be recognized in the carve-out financial statements in the period that it is incurred. ASC 715-30-35-70 indicates that multiple-employer plans should be considered single employer plans. As a result, if the carve-out entity elects multiple-employer plan accounting, it should include the service component costs in the same line items as other compensation costs. The other components (e.g., interest costs, actual return on plan assets, amortization of prior service cost, actuarial gains and losses) should be included outside of income from operations.

5.6 Gain or loss on hedging instruments

Some derivative instruments issued by the parent entity are meant to economically hedge transactions recorded in the carve-out financial statements that have not been designated as hedges for accounting purposes. If the derivative has not been recorded in the carve-out financial statements, the carve-out business may elect to either record or exclude the income statement effect of the derivative instrument in its financial statements. In either case, the methodology should be followed consistently and with appropriate disclosure.

5.7 Interest expense (third-party debt)

Third-party debt issued directly by the carve-out business would be reflected in the carve-out financial statements. Accordingly, the related interest expense would be directly attributable to the carve-out business. Any discount, interest, and fees associated with the debt should also be reflected. See CO 5.9.1 for the treatment of interest expense on intercompany debt.

5.8 Income taxes

Preparing the tax provision for carve-out financial statements can be challenging, particularly if separate financial statements (including a tax provision) have not historically been prepared or the carve-out business was not a stand-alone tax paying entity. However, taxable entities must include a tax provision in the carve-out financial statements.

The carve-out entity's tax provisions should be based on the financial statement accounts of the carve-out business. Reflecting the appropriate tax effect requires a full understanding of the pre-tax accounts included in the carve-out financial statements, as well as the allocation methodologies used. The carve-out business will often have a tax profile that differs from the parent with respect to state, local, and foreign taxes. Accordingly, the carve-out business may need to prepare a separate tax provision calculation for each material jurisdiction in which the carve-out operations take place.

Guidance provided by the SEC staff in SAB Topic 1.B.1 Question 3 (codified in ASC 220-10-S99) should be considered when preparing the income tax provision.

Excerpt from ASC 220-10-S99-3

Question 3: What are the staff's views with respect to the accounting for and disclosure of the subsidiary's income tax expense?

Interpretive Response: Recently, a number of parent companies have sold interests in subsidiaries, but have retained sufficient ownership interests to permit continued inclusion of the subsidiaries in their consolidated tax returns. The staff believes that it is material to investors to know what the effect on income would have been if the registrant had not been eligible to be included in a consolidated income tax return with its parent. Some of these subsidiaries have calculated their tax provision on the separate return basis, which the staff believes is the preferable method. Others, however, have used different allocation methods. When the historical income statements in the filing do not reflect the tax provision on the separate return basis, the staff has required a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis.(1)

(1) Paragraph 40 of Statement 109 [paragraph 740-10-30-27 (Income Tax Topic)] states: "The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements.... The method adopted... shall be systematic, rational, and consistent with the broad principles established by [Statement 109] [Subtopic 740-10]. A method that allocates current and deferred taxes to members of the group by applying this [Statement 109] [Subtopic 740-10] to each member as if it were a separate taxpayer meets those criteria."

There are many tax considerations related to carve-out financial statements, including whether to use the separate return method, uncertain tax provisions, indefinite reinvestment, and valuation allowances. See TX 14 for additional information on these topics.

5.9 Intercompany transactions

Historical intercompany transactions of the carve-out business and parent company must be identified and evaluated for proper presentation within the carve-out financial statements. Examples of transactions and balances with affiliated entities may include the following:

- Sales between the carve-out business and affiliated entities. Historical transactions might not reflect arms-length terms because they were related party transactions. However, the transaction amounts should not be adjusted.

- Corporate overhead provided by the parent entity for the carve-out business (e.g., payroll processing services, supplies, equipment, services such as global research center, centralized purchasing, legal, and corporate internal audit services)

- Employee charges (e.g., a group of marketing employees from the parent entity was brought onto a specific project for the carve-out business)

Transactions that were historically eliminated in the consolidation of the parent entity's financial statements, now represent transactions with related parties. These related party transactions require separate disclosure. See CO 6.2.3 for further discussion of related party disclosures.

In other cases, intercompany transactions not previously recorded between the carve-out business and parent company will need to be recognized in the carve-out financial statements.

Intercompany transactions and balances between subsidiaries within the carve-out business will continue to be eliminated in preparing the carve-out financial statements.

5.9.1 Interest expense on intercompany debt

Intercompany debt and the related interest expense are generally presented in the carve-out financial statements when supported by a written agreement that includes principal amounts, interest rate, maturity date, etc.

An interest charge may not have historically been recorded on intercompany debt due from the carve-out business to its parent or affiliate. In evaluating whether interest expense should be recorded when it was not provided in the past, the guidance in SAB Topic 1.B.1 Question 4 (codified in ASC 220-10-S99-3) should be considered.

Excerpt from ASC 220-10-S99-3

Question 4: Should the historical income statements reflect a charge for interest on intercompany debt if no such charge had been previously provided?

Interpretive Response: The staff generally believes that financial statements are more useful to investors if they reflect all costs of doing business, including interest costs. Because of the inherent difficulty in distinguishing the elements of a subsidiary's capital structure, the staff has not insisted that the historical income statements include an interest charge on intercompany debt if such a charge was not provided in the past, except when debt specifically related to the operations of the subsidiary and previously carried on the parent's books will henceforth be recorded in the subsidiary's books. In any case, financing arrangements with the parent must be discussed in a note to the financial statements. In this connection, the staff has taken the position that, where an interest charge on intercompany debt has not been provided, appropriate disclosure would include an analysis of the intercompany accounts as well as the average balance due to or from related parties for each period for which an income statement is required. The analysis of the intercompany accounts has taken the form of a listing of transactions (e.g., the allocation of costs to the subsidiary, intercompany purchases, and cash transfers between entities) for each period for which an income statement was required, reconciled to the intercompany accounts reflected in the balance sheets.

Interest expense related to intercompany debt previously recorded in the carve-out financial statements remains in the carve-out financial statements.

5.9.2 Taxes on intercompany transactions

Intercompany transactions that were formerly eliminated in the parent entity consolidated financial statements generally would not be eliminated in the carve-out financial statements. Accordingly, the income tax accounting for those transactions would also change. Specifically, the guidance in ASC 740-10-25-3(e), which prescribes the accounting for the income tax effects of intercompany inventory transactions, would not apply to such transactions in the carve-out financial statements. It would also be necessary for management to assess whether the income tax accounting effects of certain intercompany transactions are required to be recorded in equity in accordance with ASC 740-20-45-11(c) or ASC 740-20-45-11(g). See TX 14.8 for additional information on intercompany considerations related to taxes in carve-out financial statements.

5.10 Transaction-related costs

Transaction costs of a divestiture may include finder’s fees, and advisory, legal, accounting, valuation, and other professional or consulting fees. Consideration should be given to which entity (the parent entity or the carve-out business) benefitted as a result of each transaction cost. If the carve-out entity derived any benefit, the transaction-related cost should be allocated to the carve-out financial statements based on the methods described in CO 5.2.

Additionally, it is not uncommon for a parent to pay a one-time “stay bonus” to employees of the carve-out business to entice the employees to continue their employment with the carve-out business through the transaction date. As the carve-out business continues to benefit from the service provided by these employees, we believe the carve-out entity should analogize to the guidance in SAB Topics 1.B and 5.T, and accordingly, record an expense in the carve-out financial statements related to this arrangement.

5.11 Exit or disposal costs

As part of the divestiture transaction, the parent entity may incur exit or disposal costs as it restructures its operations. To the extent that the restructuring costs related to the historical operations of the carve-out business, an amount should be recorded in the carve-out financial statements. The restructuring costs may need to be allocated to the carve-out financial statements based on the methods described in CO 5.2.

Chapter 6: Disclosures and certain presentation matters–updated April 2024

6.1 Disclosures and certain presentation matters–overview

This chapter includes a discussion of disclosure considerations and certain presentation matters that arise when preparing carve-out financial statements. Although a divestiture transaction will result in disclosure considerations and other issues for the parent entity, this guide does not address the impact of the transaction on the parent entity. See PPE 5 for held-for-sale accounting considerations and FSP 27 for accounting for discontinued operations.

6.2 Disclosures

As neither US GAAP nor the SEC provide comprehensive guidance on preparing carve-out financial statements, disclosures are important to enable users to understand how the carve-out financial statements have been prepared. The nature and content of the disclosures describing the carve-out business may vary; however, given the nature of carve-out financial statements, disclosures typically include a description of the business, basis of presentation, and related party disclosures.

6.2.1 Description of the business

A description of the business often provides insights into the nature and scope of the carve-out business. It will typically include a description of the entities, businesses, or divisions included in the carve-out financial statements as well as whether the financial statements were prepared on a combined or consolidated basis. See CO 3.1 for further information regarding combined financial statements vs. consolidated financial statements.

6.2.2 Basis of presentation

The basis of presentation disclosure typically consists of the following elements:

- The financial reporting framework under which the financial statements have been prepared
- A statement that the carve-out business is part of a larger reporting entity and the nature of the relationship between the carve-out business and the parent entity
- A statement that the carve-out financial statements may not be indicative of what the carve-out business would have been as a stand-alone entity.
- The approach and methodology of significant allocations used in preparation of the carve-out financial statements, including management's assertion that the allocation method used is reasonable.
- Accounting policy disclosures. These are typically included for items such as cash and cash equivalents, pension accounting, and net parent investment, among others, to give financial statement users insight into items for which the basis of presentation may be specific to a carve-out.

6.2.3 *Related party disclosures*

Many transactions that were historically eliminated in consolidation by the parent entity are now recorded in the carve-out financial statements as transactions with affiliated entities. These transactions should be disclosed in accordance with ASC 850, *Related Party Disclosures*. Carve-out financial statements filed with the SEC will need to comply with the presentation requirements in Regulation S-X Rule 4-08(k).

An estimate, when practicable, of what the expenses from related party agreements (other than income taxes and interest) would have been on a standalone basis should be disclosed as required by Question 2 of SAB Topic 1.B, *Allocation Of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity* (codified in ASC 220-10-S99-3). This disclosure is required for each year for which an income statement is presented when such basis would have produced materially different results.

Financing arrangements with the parent should be disclosed, as required by Question 4 of SAB Topic 1.B.

6.2.4 *Subsequent events*

Events that occur after the most recent balance sheet date must be analyzed under ASC 855, *Subsequent Events,* to determine whether such events require recognition in the financial statements or disclosure.

It is generally acceptable for a reporting entity that is a subsidiary of another entity to only consider for recognition subsequent events that occur through the date the parent entity's consolidated financial statements are issued (if the parent is a public entity) or available to be issued (if the parent is a non-public entity). Disclosure of nonrecognized subsequent events may still be required. See FSP 28.7 for more information.

Refer to FSP 28.8 for further guidance on the evaluation of subsequent events upon reissuance of financial statements.

6.2.5 *Income taxes*

When a reporting entity is a member of a group that files a consolidated tax return, it must make certain income tax disclosures. See FSP 16.7.3 for additional information.

As noted in Question 3 of SAB Topic 1.B.1, if the income statement does not reflect the tax provision on the separate return basis, a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis is required. See TX 14.2.1 for further discussion of the separate return method.

6.2.6 *Segments*

Public entities, as defined by ASC 280-10-15-2 through ASC 280-10-15-3, are required to include disclosures about their segments. As a result of the specific definition in ASC 280, *Segment Reporting*, reporting entities that are registering securities with the SEC (e.g., an initial public offering or spin-off) are required to include a segment footnote; however, financial statements prepared to comply with Regulation S-X Rule 3-05 or Regulation S-X Rule 8-04 do not need to include a segment footnote. If a

segment footnote is required, management will need to determine segments from the perspective of the chief operating decision maker of the carve-out entity. See FSP 25 for more on segments.

6.3 Statement of changes in equity

When the carve-out business is a separate legal entity, the statement of changes in equity will reflect the historical equity structure of the legal entity. When the carve-out business is not a separate legal entity, the statement of changes in equity in carve-out financial statements may be limited to presenting changes in the parent's net investment, accumulated other comprehensive income, and noncontrolling interests (if applicable).

Example CO 6-1 provides an equity presentation in a carve-out entity's statement of stockholders' equity.

EXAMPLE CO 6-1

Statement of stockholders' equity in carve-out financial statements

Company X was spun out from its Parent Entity on October 31, 20X1. Net parent investment was $1,000 and accumulated other comprehensive loss was $(100) at December 31, 20X0.

During the period January 1, 20X1 to October 31, 20X1:

- net income was $50,
- intercompany activity with the Parent Entity was $(20), and
- other comprehensive income was $10.

Common stock with a par value of $50 was issued on October 31, 20X1. Net income was $5 during the period of November 1, 20X1 to December 31, 20X1.

How should Company X present its statement of stockholders' equity for the year ended December 31, 20X1?

Analysis

The following reflects the Company X's statement of stockholders' equity. Note that "Net parent investment" is adjusted to $0 on the spin-off date to reflect the new equity structure.

	For the year ended December 31, 20X1					
	Common stock	Additional paid-in capital	Net parent investment	Accumulated other comprehensive income/(loss)	Retained earnings	Total stockholder s' equity
Balance at December 31, 20X0	$--	$--	$1,000	$(100)	$--	$900
Net income	--	--	50	--	--	50
Net decrease in net parent investment	--	--	(20)	--	--	(20)
Other comprehensive income	--	--	--	10	--	10
Consummation of separation transaction on October 31, 20X1	50	980	(1,030)	--	--	-
Net income	-	-	-	-	5	5
Balance at December 31, 20X1	$50	$980	$0	$(90)	$5	$945

6.4 Statement of cash flows

If the bank accounts used by the carve-out business are not in the name of the carve-out business, or cash was swept into a parent account, cash may not be reflected on the balance sheet of the carve-out financial statements. Even so, ASC 230-10-15 would still apply and information regarding cash inflows and outflows would be required.

The statement of cash flows of a carve-out business is derived from its financial statements (i.e., balance sheet and income statement). Management should prepare the statement of cash flows for the carve-out business utilizing carve-out-specific information. The preparation of the statement of cash flows can be complex. Certain financial statement line items (e.g., fixed assets) may have a number of shared assets or commingled transactions that require close attention by management to determine the proper cash flow presentation. For example, management may need to develop a new process to

identify fixed asset purchases unpaid as of the end of the reporting period that relate to the carve-out business.

While intercompany transactions are eliminated in the parent entity financial statements, the carve-out statement of cash flows will reflect these transactions. The nature of the related party transaction should be considered to determine the appropriate presentation in the statement of cash flows. For example, receivables and payables due to/from affiliated entities that relate to intercompany sales/purchases and that are intended to be repaid would be reflected as operating cash flows. Executed notes receivable/payable with affiliates would typically result in investing or financing activities, respectively.

Many entities use centralized treasury functions in which the parent reporting entity controls all cash transactions on behalf of its subsidiaries and maintains all cash accounts. This kind of arrangement results in due to/from parent in the carve-out entity's standalone financial statements since the parent makes all cash payments on behalf of the carve-out entity and sweeps all cash balances. In such circumstances, the intercompany net due to/from parent is, in substance, the carve-out entity's cash account. As a result, changes in the due to/from parent account should be reflected as actual cash flows in the carve-out entity's standalone statement of cash flows.

A parent and the carve-out entity could classify the cash flow activity associated with the due to/from parent account as financing activities based upon the consolidating statement of cash flows example included in ASC 830-230-55-2.

Alternatively, the cash flow classification could be based on whether the balance is a net due to or a net due from parent. That is, if the balance sheet shows a net due from parent, the carve-out entity would classify the cash flows as investing, as this balance is akin to a loan, as contemplated by ASC 230-10-45-12a and ASC 230-10-45-13a. However, if a carve-out entity's balance sheet reflects a net due to parent, the carve-out entity would classify the cash flows as financing, as this balance is similar to issuing debt.

Management should consider the effect of changes in the taxes payable balance on the statement of cash flows. Generally, income tax expense would result in an increase in income taxes payable, which is shown as a non-cash "add back" to the operating cash flows. Only actual cash paid for taxes by the carve-out business would be shown as an operating cash outflow. If the parent entity paid taxes on behalf of the carve-out business, these transactions and the taxes payable balance would be treated in a manner similar to other intercompany transactions.

6.5 Pro forma financial information

If the carve-out financial statements are part of a registration statement, SAB Topic 1.B.2 requires pro forma financial information when the carve-out financial statements are not indicative of the ongoing entity. The pro forma financial information should be in accordance with Regulation S-X Article 11.

A pro forma balance sheet as of the most recent balance sheet date and an income statement for the most recently completed fiscal year and subsequent year-to-date interim period included in the SEC filing are generally required. The three types of pro forma adjustments under Regulation S-X Article 11 are: (1) transaction accounting adjustments, (2) autonomous entity adjustments, and (3) management's adjustments. Transaction accounting and autonomous entity adjustments are presented in separate columns in the pro forma information, and management's adjustments, if any

are identified, are included within the accompanying footnotes. The first two adjustment types are required when applicable, and the third adjustment type, which is meant to reflect synergies or the lack of synergies, is optional.

If the carve-out financial statements are being prepared in connection with the acquisition of a business, the historical financial information of the buyer and acquired business must be within one quarter of each other, if practicable. Pro forma transaction accounting adjustments reflect the accounting for the transaction under GAAP and would include items such as the allocation of the purchase price and conforming accounting policy adjustments. Revenue, expenses, gains and losses and the related tax effects that are not expected to continue for a period beyond 12 months must be disclosed.

In connection with a spin-off transaction, pro forma financial information would reflect autonomous entity adjustments such as new contractual arrangements with the former parent. The pro forma financial information may also need to reflect transaction accounting adjustments, such as the divestiture of assets or depooling of businesses that were included in the carve-out financial statements but that will not be transferred in connection with the spin-off.

See SEC 4560, *Pro Forma Financial Information*, for additional information.

6.6 Earnings per share

If the carve-out business is not a legal entity, the financial statements likely reflect "parent's net investment" in lieu of a more traditional equity structure, as discussed in CO 4.4.1. As such, earnings per share would not be presented. If the form of the transaction includes a registration statement, any financial statement presentation after the reorganization of the carve-out business into a legal entity will reflect EPS for all periods presented, as discussed below. In cases when the carve-out entity is the issuer of an IPO, pro forma EPS may be required. See FSP 7.7 for further consideration of pro forma information.

6.6.1 EPS for a newly-formed entity

When calculating basic EPS for a newly-formed entity, the denominator for the periods prior to formation is the number of shares at formation. When calculating diluted EPS, the dilutive effects of stock options granted by the carve-out business should be considered from the grant date. Options to purchase shares of the parent entity are not included in the carve-out entity's diluted EPS. See FSP 7.6.4 for further guidance on computing EPS in an IPO or spin-off of a subsidiary.

6.6.2 EPS for an existing subsidiary

With respect to an existing subsidiary (i.e., an entity with a separate legal identity), the historical weighted average number of shares outstanding during each period is reflected in the denominator and EPS for all periods presented. Issuance of shares to new investors in connection with the IPO/spin-off is treated prospectively from the issuance date. If there is a stock split, the EPS should be restated for all periods presented. See FSP 7.6.4 for further guidance on computing EPS in an IPO or spin-off of a subsidiary.

6.7 Discontinued operations

Discontinued operations may be relevant for a carve-out business if either a part of the business historically included in the operations of the carve-out business will not be included in the divestiture transaction or if a part of the carve-out business was previously presented as discontinued operations in the historical financial statements of the parent entity. See FSP 27 for further guidance on the presentation of discontinued operations.

Discontinued operations will be rare under the management approach as the management approach includes only the net assets and related historical results that are being transferred as part of the divestiture transaction; however, discontinued operations could be relevant under the legal entity approach for a carve-out business in a spin-off when significant operations of the carve-out business remain with the parent.

Example CO 6-2 provides an example of assessing the discontinued operations criteria related to operations that are part of the historical results of a carve-out business but will remain with the parent.

EXAMPLE CO 6-2

Discontinued operations of a carve-out business applying the legal entity approach in a spin-off

Parent Entity intends to spin off a subsidiary, Company X, on October 31, 20X1. The carve-out financial statements of Company X are prepared under the legal entity approach. In September 20X1, Parent Entity decided that it will retain certain significant operations of Company X, which meet the definition of a component under ASC 205-20-20. Company X transfers the operations to be retained to Parent Entity on October 30, 20X1. For Company X, the spin-off represents a strategic shift that will have a major effect on its financial results.

How should Company X present the operations that it transfers to Parent Entity in its financial statements for the interim period ended September 30, 20X1 and the annual period ended December 31, 20X1?

Analysis

For a component to qualify as a discontinued operation at the balance sheet date, it must be disposed of (e.g., through sale, abandonment, or spin-off), or meet the held-for-sale criteria of ASC 360-10-45-9. As the operations were not transferred to Parent Entity until October 30, 20X1, the operations are not considered to be disposed of as of September 30, 20X1. Further, the operations will not meet the held-for-sale criteria because Company X is not selling the operations. Therefore, Company X should present the operations that it will transfer to Parent Entity as held and use and within continuing operations in its statement of operations for the interim period ended September 30, 20X1.

Company X should present the operations transferred to Parent Entity as discontinued operations in its statement of operations for the year ended December 31, 20X1 as the component was disposed of at the balance sheet date, and the operations represented a strategic shift that had a major effect on its financial results.

Even though the distribution to Parent Entity occurred before the end of a reporting period and therefore there are no assets and liabilities remaining on the current year balance sheet related to the

disposal group, the prior period balance sheet must be recast. In a disposal transaction that qualifies as discontinued operations, ASC 205-20-45-10 requires the assets and liabilities of the entity being spun (i.e., being distributed to Parent Entity) to be presented separately in the assets and liabilities section of prior balance sheets. As such, if a comparable balance sheet is required for December 31, 20X0, reclassification of the assets and liabilities distributed to the Parent Entity into captions such as current and noncurrent assets of the discontinued operations and current and noncurrent liabilities of the discontinued operation would be required. The assets and liabilities cannot be netted as a single amount.

6.8 Dividends declared subsequent to the balance sheet date

As noted in SAB Topic 1.B.3, dividends declared by the carve-out entity subsequent to the balance sheet date should either be given retroactive effect in the balance sheet with appropriate footnote disclosure or reflected in a pro forma balance sheet. In addition, when the dividends are to be paid from the proceeds of the offering, the SEC staff believes it is appropriate to include pro forma per share data (for the latest year and interim period only) giving effect to the number of shares whose proceeds are to be used to pay the dividend. A similar presentation is appropriate when dividends exceed earnings in the current year, even though the stated use of proceeds is other than for the payment of dividends. In these situations, pro forma per share data should give effect to the increase in the number of shares which, when multiplied by the offering price, would be sufficient to replace the capital in excess of earnings being withdrawn. However, the pro forma EPS computation should not reflect more shares than will be outstanding after the offering. See SEC FRM 3420.2.