Viewpoint

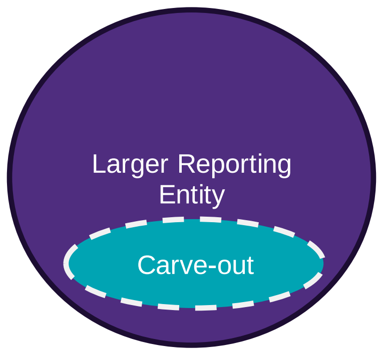
Carve-out financial statements

April 2025

Contents

Introduction

A “carve-out” is a depiction of the historical assets, liabilities, and operations of a component of a larger reporting entity.



A carve-out may comprise a legal entity (or a group of legal entities) of a larger reporting entity that did not previously prepare standalone financial statements, or it may be only a portion of a legal entity or (several legal entities), such as a division, product line, or segment.

The need for carve-out financial statements generally arises in connection with a transaction involving a component of a larger entity. However, there is limited authoritative guidance regarding when it is appropriate to present, as well as how to prepare, carve-out financial statements, so entities must use significant judgment in their preparation. This publication highlights some of the complex areas of guidance for entities to consider when preparing carve-out financial statements. It provides excerpts of relevant authoritative and interpretive guidance, primarily from U.S. GAAP as well as SEC Staff Accounting Bulletins and Section 2065 of the *Financial Reporting Manual* (FRM) published by the staff of SEC’s Division of Corporation Finance (CorpFin). Although the SEC staff guidance is principally applicable to financial statements filed with the SEC, it is relevant for private companies in preparing carve-out financial statements as well.

This publication focuses on the preparation of carve-out financial statements only under U.S. GAAP.

Situations when carve-out financial statements may be appropriate

Entities may either desire or be required by contract or regulation to present carve-out financial statements when engaging in a transaction involving a component of a larger reporting entity. Examples of when carve-out financial statements may be appropriate or required include the following:

- *Regulatory requirements:* Common examples in which SEC rules and regulations may require carve-out financial statements include
  - An IPO of a component of a larger entity
  - A spin-off transaction by a registrant

  - An acquisition of a significant business that is a component of a larger entity by a registrant

- *Other requests:* Even if there is no regulatory requirement to present carve-out financial statements, a stakeholder (for example, a bank or a potential buyer) may request the historical financial statements of a carve-out reporting entity upon the anticipation or occurrence of a transaction, such as the sale of a business by a private company. Such financial statements may be required for due diligence purposes, to build valuation models, or to be incorporated in marketing materials.

Form of financial statements

Management should use care when preparing carve-out financial statements to make sure that they address all end-user needs and comply with any relevant regulatory or contractual requirements. The form and content of the financial statements is a key part of addressing user needs, including considerations regarding the appropriate financial framework to apply or whether the financial statements will be "special purpose" (that is, not adhering to, or deviating from, a recognized financial reporting framework). It also includes decisions on which primary statements and footnotes to present, as well as the content to include in those primary statements and footnotes. Additionally, an evaluation of the form and content of the financial statements for compliance with SEC rules and regulations is necessary if the statements are included in SEC filings. A nonpublic entity may prepare carve-out financial statements for a portion of its business that it intends to sell to another private entity, such as a nonpublic operating company or private equity entity. Assuming the reporting entity is not filing special purpose financial statements, the carve-out financial statements are generally not subject to SEC requirements but must adhere to U.S. GAAP or another recognized reporting framework, unless the entity elects to voluntarily follow SEC requirements or the potential buyer requires SEC compliance by contract.

When applying U.S. GAAP, an entity must consider ASC 205-10-45-1A, which specifies what must be included in a full set of financial statements. If financial statements are prepared on a special purpose basis, the entity must ensure that the financial statements still meet the needs of the users of the financial statements.

ASC 205-10-45-1A

A full set of financial statements for a period shall show all of the following:

a. Financial position at the end of the period

b. Earnings (net income) for the period, (which may be presented as a separate statement or within a continuous statement of comprehensive income [see paragraph 220-10-45-1A])

c. Comprehensive income (total nonowner changes in equity) for the period in one statement or two separate but consecutive statements (if the reporting entity is required to report comprehensive income, see paragraph 220-10-15-3)

d. Cash flows during the period

e. Investments by and distributions to owners during the period.

Entities should carefully determine in advance which reporting periods should be included in a set of carve-out financial statements, which depends on regulatory requirements, contractual requirements, or other stakeholder needs. An entity should also consider the guidance in ASC 205-10-45-1, which notes that comparative financial statements enhance the usefulness of information and focus more clearly on the nature and trends of current changes affecting an entity. As such, financial statements for a series of periods are far more significant than those for a single period.

ASC 205-10-45-1

The presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the entity. Such presentation emphasizes the fact that statements for a series of periods are far more significant than those for a single period and that the accounts for one period are but an installment of what is essentially a continuous history.

1. Defining the carve-out

A carve-out represents the historical assets, liabilities, and operations of a component within a larger reporting entity. The circumscribed area of economic activities (that is, the parameters) constituting the carve-out entity may be clearly defined; for example, it could encompass all the assets, liabilities, and operations of a subsidiary of a reporting entity. Conversely, the circumscribed area of economic activities might represent a component of a legal entity, such as a division, or might be intermingled across multiple divisions or legal entities. Consequently, a carve-out entity can consist of a single legal entity (or a group of legal entities) or a portion of a legal entity (or a portion of several legal entities).

Defining the carve-out should take into consideration a number of factors, including, but not limited to, the legal structure and form of the transaction to which the carve-outs financials relate, users of the financial statements, and relevant reporting requirements.

The FASB addressed carve-out entities in Chapter 2 of the Conceptual Framework (Concepts Statement 8), noting that a portion of a larger entity may qualify as its own reporting entity if it represents a circumscribed area of economic activities and can faithfully represent those economic activities in general purpose financial reporting.

Chapter 2, "The Reporting Entity," of FASB Concepts Statement 8

RE11

A portion of a larger entity, such as a subsidiary, branch, or division, can represent a circumscribed area of economic activities and, consequently, meet the description and features of a reporting entity in paragraphs RE4 and RE5. A portion of a larger entity would still need to consolidate any of its own subsidiary relationships to meet the objective of general purpose financial reporting, consistent with paragraph RE8.

RE12

For a portion of a larger entity to prepare general purpose financial reports, including a full set of financial statements, it must identify the economic activities of its circumscribed area. Decisions on which economic activities should be attributable to the portion of a larger entity should result in general purpose financial reports that provide a faithful representation of the portion of the larger entity's financial position and performance.

RE13

Based on the needs of intended users, the portion of an entity may prepare financial reports that do not include a full set of financial statements. In those circumstances, the financial reports are special purpose. Because those special purpose financial reports do not completely depict the portion of an entity's circumscribed area of economic activities, the financial reports would not be considered general purpose financial reporting.

Basis of Conclusions (BC) 2.10

The Board concluded that a portion of a larger entity can qualify as a reporting entity if the portion of the entity represents a circumscribed area of economic activities whose financial information can be faithfully represented in general purpose financial reporting.

BC2.11

The Board acknowledges that in some cases there are practical complexities in identifying the assets, liabilities, and operations of a portion of an entity, specifically for items that are allocated to the portion of the entity. To achieve the objective of general purpose financial reporting, the portion of a larger entity must prepare general purpose financial reports, including a full set of financial statements, that faithfully represent the economic activities of its circumscribed area, including activities that have to be allocated to the portion of the entity, such as corporate overhead activities.

The information in Chapter 2 of FASB Concepts Statement 8 is designed to help entities define a carve-out entity. In practice, there are two broad approaches used to capture the circumscribed area of economic activity of a carve-out entity:

- The legal entity approach; and
- The management approach.

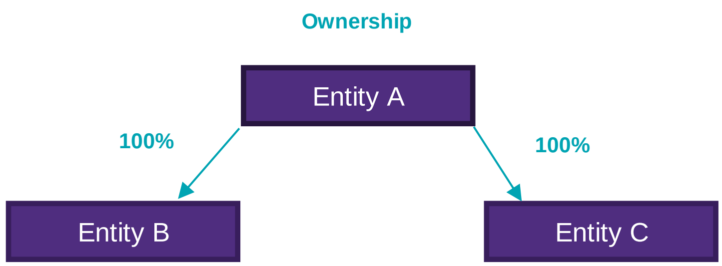
1.1 Legal entity approach

The legal entity approach is based on the legal structure of the parent entity. The carve-out entity is defined by the assets, liabilities, and activities in the legal entity or entities being carved out.

When preparing carve-out financial statements under the legal entity approach, a preparer will have to consider if the carve-out financial statements are those of a "standalone legal entity" or "consolidated" or "combined" financial statements, as follows:

- *Standalone legal entity financial statements* represent the financial position and results of operations of a single legal entity.
- *Consolidated financial statements* represent the financial position and results of operations of a consolidated group of entities, including a parent and its subsidiaries, presented as a single economic entity. ASC 810 requires a reporting entity to consolidate another legal entity in which the reporting entity has a controlling financial interest.
- *Combined financial statements* represent the financial position and results of operations of a combined group of commonly controlled or commonly managed entities, excluding the parent entity, presented as a single economic entity. The key difference between consolidated and combined financial statements is that there is no controlling financial interest among the entities being combined. ASC 810 gives examples of when combined financial statements may be useful but does not require their preparation. Combined financial statements may be useful, for instance, if one

individual owns a controlling financial interest in several entities that are related in their operations. Combined financial statements might also be used to present the financial position and results of operations of entities under common management.



In the diagram above, if the financial position of Entities A, B, and C were reported together in a single set of financial statements, for example, these would be considered consolidated financial statements because Entity A owns and has the controlling financial interest in Entities B and C. However, if Entities B and C are reported together, excluding the parent (Entity A), then those financial statements would be considered combined financial statements.

Whether management is preparing standalone, consolidated, or combined financial statements for a component of a larger entity, the concepts discussed throughout this publication related to preparing the carve-out financial statements apply.

The legal entity approach is ordinarily used if all (or substantially all) of a legal entity or entities represents the carve-out entity. Under this approach, assets, liabilities and activities that will not be a part of the carve-out entity after the consummation of the transaction are still reflected in the historical financial statements. Upon consummation, such assets, liabilities and activities are ordinarily accounted as a disposition.

1.2 Management approach

Under the management approach, an entity uses information about how the carve-out entity was historically managed, as well as which assets and liabilities were sold, as a way of defining the parameters of the carve-out. The management approach is ordinarily appropriate when an area of economic activity is being carved out from legal entities and certain operations are retained by the parent. An entity must have an objective basis for delineating a specific economic area within an entity, often defined by the terms of the transaction under which the carve-out financials are being prepared. The management approach is utilized when the activities of an entire legal entity (or entities) are not consistent with the carve-out being represented; thus, this approach is likely to provide more useful information. In making this assessment, an entity must carefully consider all relevant facts and circumstances to determine if the exclusion of any historical assets, liabilities, and economic activities is appropriate and accurately reflects how the carve-out entity was historically managed and performed. For example, if a registrant acquires assets, liabilities, and operations that constitute less than substantially all of the seller, the management approach would ordinarily be used.

Prior to the initiation of certain transactions, such as an IPO, management may transfer certain assets and liabilities into a new legal entity using a common control transaction. If the new legal entity receiving the assets and liabilities is the registrant, the management approach may, depending on facts and circumstances, then be used to reflect the historical activity of the new legal entity for reporting periods before the transfer. However, if the parent entity transferring assets to a different legal entity will be the registrant, additional considerations need to be made. See Section 1.3, "Depicting all the historical activity of an entire legal entity (application of SAB Topic 5.Z.7)." Oftentimes, such determination may be complex, and the registrant may decide to preclear their conclusion with the SEC staff prior to filing the registration statement.

1.3 Depicting all the historical activity of an entire legal entity (application of SAB Topic 5.Z.7)

In some transactions, certain pre-transaction assets, liabilities, and activities of a legal entity may be distributed or otherwise transferred to the entity's pre-transaction parent through a distribution or similar transaction. A transaction between a parent and a subsidiary would be considered a common control transaction.

Under the legal entity approach, the historical financial statements of the legal entity would include all of the assets, liabilities, and activities, including the assets, liabilities, and activities prior to the distribution to the pre-transaction parent. In the financial statements of the legal entity for the period in which the distribution occurred, the reporting entity would have to carefully consider whether the discontinued operations criteria in ASC 205-20 are met in relation to the assets, liabilities, and activities distributed to the pre-transaction parent. As the distribution to the pre-transaction parent would be accounted for as a common control transaction, the difference between any consideration received from the pre-transaction parent and the book value of the net assets distributed would be recognized in equity.

However, when this type of common control transaction is effectuated, the reporting entity may, in certain circumstances, account for this transaction as a change in reporting entity under ASC 250. In other words, the entity may determine that the pre-transaction historical periods presented in the financial statements should exclude the assets, liabilities, and activities that were distributed to the pre-transaction parent (that is, the assets, liabilities, and activities should be de-pooled from the legal entity). The reporting entity may, if certain conditions are met, exclude from its historical financial statements the activity that was distributed to the pre-transaction parent.

As explained in SAB Topic 5.Z.7, now codified in ASC 505, the Commission has not objected in the past to financial statements that retroactively reflect a reorganization of a business in an initial registration statement (that is, presenting the historical financial statements of the legal entity de-pooled, which means excluding the activity of the subsidiary distributed to the shareholders), if the distribution or transfer occurs before the registration statement is effective and certain other conditions are met. This presentation may be acceptable in an initial registration if the entity and the subsidiary being spun off meet all of the following conditions:

- They conduct dissimilar businesses;
- Each entity has been managed and financed historically as though it were an autonomous entity;
- They share no more than incidental common facilities and costs;
- Each entity will be operated and financed autonomously after the spin-off; and
- Each entity will not have material financial commitments, guarantees, or contingent liabilities to each other after the spin-off.

In practice, many of these conditions are difficult to meet, and the application of SAB Topic 5.Z.7 may therefore be limited. If the conditions are met, however, the presentation effectively results in a change in the reporting entity. Further, under these circumstances, discontinued operations considerations in accordance with ASC 205-20 would not be relevant in the reporting period that includes the distribution, as the distributed assets, liabilities, and activities would not be in the historical financial statements to begin with.

If the conditions are not met, the financial statements may be required to depict all the historical activity of the entire legal entity. In other words, the legal entity approach would be required, and use of the management approach would be prohibited, in this scenario.

ASC 505-60-S991 (codified SEC SAB Topic 5.Z.7)

The following is the text of SAB Topic 5.Z.7, Accounting for the Spin-off of a Subsidiary.

Facts: A Company disposes of a business through the distribution of a subsidiary's stock to the Company's shareholders on a pro rata basis in a transaction that is referred to as a spin-off.

Question: May the Company elect to characterize the spin-off transaction as resulting in a change in the reporting entity and restate its historical financial statements as if the Company never had an investment in the subsidiary, in the manner specified by FASB ASC Topic 250, Accounting Changes and Error Corrections?

Interpretive Response: Not ordinarily. If the Company was required to file periodic reports under the Exchange Act within one year prior to the spin-off, the staff believes the Company should reflect the disposition in conformity with FASB ASC Topic 360. This presentation most fairly and completely depicts for investors the effects of the previous and current organization of the Company. However, in limited circumstances involving the initial registration of a company under the Exchange Act or Securities Act, the staff has not objected to financial statements that retroactively reflect the reorganization of the business as a change in the reporting entity if the spin-off transaction occurs prior to effectiveness of the registration statement. This presentation may be acceptable in an initial registration if the Company and the subsidiary are in dissimilar businesses, have been managed and financed historically as if they were autonomous, have no more than incidental common facilities and costs, will be operated and financed autonomously after the spin-off, and will not have material financial commitments, guarantees, or contingent liabilities to each other after the spin-off. This exception to the prohibition against retroactive omission of the subsidiary is intended for companies that have not distributed widely financial statements that include the spun-off subsidiary. Also, dissimilarity contemplates substantially greater differences in the nature of the businesses than those that would ordinarily distinguish reportable segments as defined by FASB ASC paragraph 280-10-50-10 (Segment Reporting Topic).

Distribution of part of a legal entity

A registrant intends to take its long-haul airline operations public. Currently, the airline’s operations consist of a short-haul legal entity (Entity S) and long-haul legal entity (Entity L), consolidated by an intermediate holding company (Entity X). Prior to the public offering of Entity X, the short-haul airline operations (Entity S) will be distributed to its parent entity, Entity P, without consideration.

Entity X is required to file consolidated financial statements of its historical operations within the registration statement. Entity X evaluates SAB Topic 5.Z.7 to determine whether it can present the consolidated historical operations of Entity X, excluding the short-haul operations of Entity S, that were distributed to Entity P prior to filing the registration statement. However, since the short-haul and long-haul operations are considered similar businesses, the de-pooling approach under SAB Topic 5.Z.7 is not applicable.

Consequently, the historical financial statements of Entity X will adopt a legal entity approach inclusive of all historical operations of Entity S and Entity L, reflecting both the short-haul and long-haul operations. If the distribution to the parent entity occurred within a period covered by the financial statements included in the registration statement, this distribution would be recorded as an equity transaction as of the transaction date. Entity X would consider the guidance on discontinued operations to determine if the short-haul operations should be presented as discontinued operations in the historical financial statements upon issuing the financial statements that include the period in which the distribution occurred.

The reporting entity may present historical financial statements in addition to the required financial statements under the management approach (that is, exclude the distributed assets, liabilities, and activities of the pre-transaction parent) if the entity is required to use the legal entity approach to present a registration statement and does not meet the de-pooling criteria. In addition, pro forma financial statements may be used (or they may be required) in the registration statement to depict the historical results of the carve-out entity without the distributed activity. Alternatively, the reporting entity may seek relief from the SEC’s CorpFin from presenting the financial statements of the full legal entity.

2. Reporting considerations

2.1 Definitions

Considering the applicability or timing of reporting requirements as well as the application of accounting standards and disclosures are important aspects when preparing any financial statements. To determine which reporting requirements, accounting standards, and disclosures apply to the financial statements, management must determine, among other considerations, if the carve-out entity meets certain definitions set out in the FASB's Master Glossary, such as an SEC registrant, a public business entity (PBE), a public entity, or an SEC filer (see page 16 for the definition of an "SEC filer").

Securities and Exchange Commission (SEC) Registrant

An entity (or an entity that is controlled by an entity) that meets any of the following criteria:

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

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

c. It provides financial statements for the purpose of issuing any class of securities in a public market.

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Public Entity

Definition 1 |Glossary Term Usage| See Topic(s): 280, 740, 805, 954, 958

A business entity or a not-for-profit entity that meets any of the following conditions:

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

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

c. It provides financial statements for the purpose of issuing any class of securities in a public market.

Definition 2 |Glossary Term Usage| See Topic(s): 740

An entity that meets any of the following criteria:

a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally).

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

c. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Definition 3 |Glossary Term Usage| See Topic(s): 470, 718

An entity that meets any of the following criteria:

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

b. Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market

c. Is controlled by an entity covered by the preceding criteria. That is, a subsidiary of a public entity is itself a public entity.

An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is not a public entity.

An entity may meet the definition of a public business entity, or one of the definitions of a public entity, solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity or public entity for purposes of financial statements that are filed or furnished with the SEC.

Certain accounting standards that were issued before the single PBE definition was added to the Master Glossary, such as ASC 280 on segments, included a unique definition of a "public entity" used only in the context of that standard. Often those standards include different or incremental accounting and disclosure requirements for a reporting entity that is considered a public entity as defined in that particular standard.

A carve-out entity whose financial statements are filed with the SEC is a PBE and would not, therefore, apply any of the accounting alternatives for private companies developed by the FASB's Private Company Council (PCC) in those financial statements. Furthermore, the effects of any PCC alternatives applied by the carve-out entity historically must be retrospectively eliminated.

It is important to note that a consolidated subsidiary of a public company is not necessarily considered to be a PBE for purposes of its standalone financial statements. A carve-out entity that does not otherwise meet the definition of a PBE on its own would be considered a PBE only if its financial statements are included in an SEC filing by its parent, by other registrants, or by issuers who are required to file or furnish financial statements with the SEC. In these cases, the entity is only a PBE for purposes of financial statements that are filed or furnished with the SEC.

There is a difference between a PBE, a public entity, and an SEC filer, as noted in the Codification's Master Glossary.

Securities and Exchange Commission (SEC) Filer

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

a. The Securities and Exchange Commission

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

Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.

An entity that is not otherwise an SEC filer, but whose financial statements are included in a submission by an SEC filer, would meet the definition of a PBE without meeting the definition of an SEC filer.
For instance, for the purposes of preparing financial statements required by Rule 3-05 of SEC Regulation

S-X, a private acquiree would qualify as a PBE, but not as an SEC filer. The distinction between a PBE and an SEC filer is important when considering which accounting standards are required to prepare certain SEC filings. For example, entities must apply certain accounting standards to SEC filings if the entity qualifies as both a PBE and an SEC filer.

The FASB frequently staggers the effective dates for new accounting standards into two distinct categories ("buckets"). In this approach, entities classified under the first category adopt the standards prior to those in the second category, with the differentiation based on the type of filer:

- *Bucket 1* – PBEs that are SEC filers, excluding entities eligible to be *smaller reporting companies* (SRCs)[1] under the SEC's definition
- *Bucket 2* – All other entities, including entities eligible to be SRCs; all other PBEs; and all nonpublic business entities, such as private companies, not-for-profit organizations, and employee benefit plans

Accordingly, management should determine carefully which adoption date category the carve-out entity falls under to determine when to adopt accounting standard updates.

2.2 Financial statements for registrants and its predecessor(s)

In the initial registration statement as well as subsequent annual and quarterly reports, financial statements are required for the registrant and its predecessor(s). In transactions such as spin-offs or put-togethers, such financial statements may be carve-out financial statements.

The term "predecessor" is broadly defined in Rule 405 of the Securities Act of 1933. For purposes of financial statements, a "predecessor" designation is ordinarily required when a registrant succeeds to substantially all of the business of another entity and the registrant's own operations prior to the succession appear insignificant relative to the operations assumed or acquired.

2.2.1 Form of financial statements

Carve-out financial statements that represent the financial statements of a registrant or its predecessor must comply with the form and content requirements applicable to PBEs as well as those for public companies, such as the guidance on earnings per share (EPS) disclosures in ASC 260 (if the carve-out financial statements represent a legal entity) and on segments in ASC 280. In addition, the financial statements need to comply with S-X Rules 3-01 through 3-04 and other applicable Regulation S-X requirements.

If the registrant qualifies to be an "emerging growth company" (EGC) as defined under the JOBS Act of 2012,[2] it may elect to comply with new or revised accounting standards in the same timeframe as an entity that is not an issuer.[3]

[1] As defined under Item 10(f) of Regulation S-K.

[2] Also refer to FRM Section 10110.

[3] As defined under Section 2(a) of the Sarbanes-Oxley Act of 2002.

An entity should also carefully evaluate which accounting standards and SEC requirements will apply once the company has gone public. This assessment will also include determining at what point the registrant meets the definition of an SEC filer.

An entity meets the definition of an SEC filer only after its registration statement is declared effective; accordingly, it is not required to follow the Accounting Standard Update (ASU) adoption dates for SEC filers, despite being a PBE, during the IPO registration process. However, after the registration statement is effective, the entity meets the definition of an SEC filer and must retrospectively adopt any updates applicable to SEC filers in future financial statements. Accordingly, it may be prudent to adopt those standards in the initial registration statement.

Timing of adoption of new accounting standards for entity that meets definition of 'SEC filer' after its registration statement is declared effective

Assume that a FASB ASU has an effective date for PBEs that are SEC filers for fiscal years beginning after December 15, 20X0. Company A files Form S-1 to register additional securities with the SEC, which includes historical audited annual financial statements and unaudited interim financial statements up to March 31, 20X1. The SEC declares that Company A's registration statement is effective in June 20X1. When Company A files the registration statement, it does not yet meet the definition of an SEC filer and therefore is not yet required to apply the new accounting amendments in its historical financial statements included within the filing. However, when the registration statement is declared effective in June 20X1, Company A becomes an SEC filer and must adopt the new amendments as of January 1, 20X1 (the date the amendments became effective for PBEs that are SEC filers) for the financial statements included in any subsequent registration statement or periodic Form 10-Q or Form 10-K filing.

2.2.2 Reporting periods required

If the carve-out financial statements of a registrant or its predecessor are included in a registration statement, then two or three years of audited annual financial statements would be required, depending on the type of registration statement and the registrant's EGC and SRC status. Interim financial statements, in addition to annual financial statements, may also be required to meet the applicable age requirements[4] under SEC rules and regulations.

2.3 Financial statements for S-X Rule 3-05

S-X Rule 3-05 requires an SEC registrant to file pre-acquisition financial statements for a recently acquired "business," as defined in S-X Rule 11-01(d), that meets certain significance thresholds outlined in S-X Rule 1-02(w). Such financial statements may also be required for probable acquisitions.

2.3.1 Definition of a 'business'

Understanding the definition of a "business" under S-X Rule 11-01(d) is important in determining whether the guidance on acquiring a business under S-X Rule 3-05 applies. It is key to note that the definition of a

[4] See S-X Rules 3-01(c) and 3-12 and S-X Rule 8-08 for SRCs.

business under S-X Rule 11-01 is different from the definition of a business under ASC 805. Accordingly, an acquisition accounted for as an asset acquisition under U.S. GAAP may or may not qualify as an acquisition of a business under SEC reporting rules. The SEC staff has reminded registrants that for SEC reporting purposes, the objective in defining a business is to determine whether additional financial statements are necessary for making investment decisions, which may not always align with the accounting determination under U.S. GAAP. Under S-X Rule 11-1, an acquisition is presumed to be an acquisition of a business if the acquisition was a separate entity, subsidiary, or division of the seller. In addition, if a registrant acquires a lesser component of a legal entity, CorpFin staff has indicated that they should presume an acquiree is a business if its revenue-producing activities remain generally the same before and after the acquisition. Further, registrants should consider the factors outlined in S-X Article 11, such as whether physical facilities, employees, or the customer base will remain with the purchased component after the transaction in determining whether an acquired entity is a business. CorpFin staff has also indicated that an acquired entity lacking any revenue might still meet the definition of a business, a determination that might require significant judgment. Entities should consider discussing all facts and circumstances with a professional adviser as well as consulting with CorpFin staff, as necessary.

SEC Regulation S-X, Article 11, *Pro forma financial information*

Rule 11-01(d), *Presentation requirements*

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.

2.3.2 Substantially all of a legal entity

When considering what assets, liabilities, and activities to depict in the financial statements required under S-X Rule 3-05, the registrant must consider if they acquired substantially all of a legal entity or less than substantially all of a legal entity. This determination will influence whether the management or legal entity approach will be used to define the carve-out entity. If the registrant acquires substantially all of the key operating assets contained within a legal entity, the financial statements of the entire legal entity from whom the assets and liabilities were acquired are ordinarily required to provide investors with a complete and comprehensive financial history of the acquired business. However, if the registrant acquires less than substantially all of the assets and liabilities within a legal entity, the financial statements for just the acquired business are required (in other words, not for the entire legal entity because that information may not be useful). The determination of what constitutes "substantially all" depends on an evaluation of the specific facts and circumstances.

CorpFin's *Financial Reporting Manual*

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.

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 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).

2.3.3 Accounting requirements for S-X Rule 3-05 financial statements

An acquired entity or business whose financial statements are presented to satisfy the requirements under S-X Rule 3-05 is considered to be a PBE for purposes of the financial statements included in the registrant's filing. Accordingly, the entity must consider which standards are applicable and the timing of the adoption of the standard. An entity may not elect to use PCC accounting alternatives in the financial statements filed with the SEC.

When financial statements of an entity that is not public are required or included in an SEC filing to satisfy S-X Rule 3-05, questions may arise about whether such financial statements and related disclosures must comply with GAAP requirements for a public entity. FRM Sections 2005.1 and 2400.5 clarify that an acquired business or equity method investee that is not a "public entity," as defined in the particular Codification section, is not required to include such disclosures in the financial statements. For example, entities that are not public are excluded from the scope of ASC 280 and are not required to include segment disclosures in financial statements filed with the SEC. Accordingly, acquired businesses or equity method investees that are not public do not need to include segment-related disclosures in their financial statements filed to satisfy S-X Rule 3-05. However, financial statements filed with the SEC should comply with the applicable Regulation S-X requirements.

2.3.4 Reporting periods required

For entities whose financial statements are being filed to satisfy S-X Rule 3-05 requirements, audited annual financial statements for a maximum of two years may be required, depending on the results of significance tests under S-X Rule 1-02(w). Interim financial statements, in addition to annual financial statements, may also be required to meet the applicable age requirements[5] under SEC rules and regulations.

2.3.5 Abbreviated financial statements

If certain qualifying conditions outlined in S-X Rule 3-05(e) are met, abbreviated financial statements may be presented for an acquired business. Abbreviated financial statements constitute an incomplete presentation of both an entity's financial position and the results of its operations under U.S. GAAP. Such financial statements have fewer, as well as different, primary statements compared to full carve-out financial statements, and do not include indirect expenses, such as corporate overhead, interest expense, and income taxes.

Abbreviated financial statements may be presented to satisfy S-X Rule 3-05 requirements if all of the following qualifying conditions are met:

- Total assets and total revenues of the acquired, or to be acquired, business after intercompany eliminations constitute 20 percent or less of the corresponding amounts for the seller and its subsidiaries as of and for the most recently completed fiscal year;
- Separate financial statements of the business have not previously been prepared;
- The acquired business was not a separate entity, a subsidiary, an "operating segment" (as defined by U.S. GAAP or by IFRS), or a division during the reporting periods for which pre-acquisition financial statements are required; and
- The seller has not maintained distinct and separate accounts of the business necessary to present separate financial statements, so it is therefore impracticable to prepare full financial statements.

Abbreviated financial statements under S-X Rule 3-05 ordinarily comprise the following information:

- Statement of assets acquired and liabilities assumed

[5] See S-X Rules 3-01(c) and 3-12 and S-X Rule 8-08 for SRCs.

- Statement of comprehensive income, which must include all expenses incurred by or on behalf of the acquired business, but may omit corporate overhead, interest on debt that is not being assumed, and income tax expense
- Certain accompanying notes to the financial statements

Businesses that include "oil- and gas-producing activities," as defined in the FASB's Master Glossary, may omit a statement of assets acquired and liabilities assumed in abbreviated financial statements. Disclosures about oil- and gas-producing activities must be provided for each full year of operations presented for an acquired (or to be acquired) business that includes significant oil- and gas-producing activities. The financial statements may present the disclosures outlined in ASC 932, especially ASC 932-235-50-3 through 50-11 and ASC 932-235-50-29 through 50-36, as unaudited supplemental information. If the prior-year reserve studies were not made, they may be computed using only production and new discovery quantities and valuation, in which case, there will be no "revision of prior estimates" amounts to include in the financial statements. Registrants may develop these disclosures based on a reserve study for the most recent year, computing the changes backward, and disclosing the method of computation in a footnote. See S-X rule 3-05(f) for further details.

S-X 3-05(e) and (f)

(e) Financial statements for net assets that constitute a business. For an acquisition of net assets that constitutes a business (e.g., an acquired or to be acquired product line), the financial statements prepared and audited in accordance with Regulation S-X may be abbreviated financial statements prepared in accordance with paragraph (e)(2) of this section if the business meets all of the qualifying conditions in paragraph (e)(1) of this section.

(1) ***Qualifying conditions.***

(i) The total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20 percent or less of such corresponding amounts of the seller and its subsidiaries consolidated as of and for the most recently completed fiscal year.

(ii) Separate financial statements for the business have not previously been prepared;

(iii) The acquired business was not a separate entity, subsidiary, operating segment (as defined in U.S. GAAP or IFRS-IASB, as applicable) or division during the periods for which the acquired business financial statements would be required; and

(iv) The seller has not maintained the distinct and separate accounts necessary to present financial statements that, absent this paragraph (e), would satisfy the requirements of this section and it is impracticable to prepare such financial statements.

(2) ***Presentation requirements.***

(i) The balance sheet may be a statement of assets acquired and liabilities assumed;

(ii) The statement of comprehensive income must include expenses incurred by or on behalf of the acquired business during the pre-acquisition financial statement periods to be presented including, but not limited to, costs of sales or services, selling, distribution, marketing, general and administrative, depreciation and amortization, and research and development, but may otherwise omit corporate overhead expense, interest expense for debt that will not be assumed by the registrant or its subsidiaries consolidated, and income tax expense. The title of the statement of comprehensive income must be appropriately modified to indicate it omits certain expenses; and

(iii) The notes to the financial statements must include:

(A) A description of the type of omitted expenses and the reason(s) why they are excluded from the financial statements.

(B) An explanation of the impracticability of preparing financial statements that include the omitted expenses.

(C) A description of how the financial statements presented are not indicative of the financial condition or results of operations of the acquired business going forward because of the omitted expenses.

(D) Information about the business's operating, investing and financing cash flows, to the extent available.

(f) ***Financial statements of a business that includes oil and gas producing activities.***

(1) Disclosures about oil and gas producing activities must be provided for each full year of operations presented for an acquired or to be acquired business that includes significant oil- and gas-producing activities (as defined in the FASB ASC Master Glossary). The financial statements may present the disclosures in FASB ASC Topic 932 *Extractive Activities—Oil and Gas,* 932-235-50-3 through 50-11 and 932-235-50-29 through 50-36 as unaudited supplemental information. If prior year reserve studies were not made, they may be computed using only production and new discovery quantities and valuation, in which case there will be no “revision of prior estimates” amounts. Registrants may develop these disclosures based on a reserve study for the most recent year, computing the changes backward. The method of computation must be disclosed in a footnote.

(2) The financial statements prepared and audited in accordance with Regulation S-X may consist of only statements of revenues and expenses that exclude 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 by the registrant or its subsidiaries consolidated if:

(i) The acquisition generates substantially all of its revenues from *oil and gas producing activities* (as defined in § 210.4-10(a)(16)); and

(ii) The qualifying conditions specified in paragraph (e)(1) of this section are met.

(3) If the financial statements are presented in accordance with paragraph (f)(2) of this section, the disclosures specified in paragraph (e)(2)(iii) of this section must be provided.

When preparing abbreviated financial statements, entities need to carefully consider which expenses are directly related to revenue-producing activities and, therefore, need to be included in the statement of comprehensive income. Costs of sales or services, selling, distribution, marketing, general and administrative, depreciation and amortization, and research and development must be included in the abbreviated financial statements. However, corporate overhead expense, interest expense for debt that will not be assumed by the registrant, and income tax expense can be omitted.

The statement of assets acquired and liabilities assumed is expected to be prepared on a historical cost basis. However, if it is impracticable to prepare the information on this basis, then CorpFin may, upon written request, permit the use of the acquisition-date purchase price allocation as the basis of preparing the statement of assets and liabilities, pursuant to S-X Rule 3-13.

CorpFin's Financial Reporting Manual provides further guidance and consideration on abbreviated financial statements.

CorpFin's *Financial Reporting Manual*

2065.5 Abbreviated Financial Statements – Statements of Assets Acquired and Liabilities Assumed – *General Requirements*

Present a statement of assets acquired and liabilities assumed as of the end of each period required to be provided under S-X 3-05, not just as of the end of the most recent period, on the basis of seller's historical GAAP carrying value. If the registrant is unable to obtain statements of assets acquired and liabilities assumed prepared on the basis of seller's historical GAAP carrying value for each of the reporting dates required by S-X 3-05 (or, if applicable, S-X 8-04), CF-OCA will consider a registrant's request to present a statement of assets acquired and liabilities assumed prepared on the basis of the allocation of the registrant's purchase price as of the acquisition date. Registrants would still need to present the statement of revenues and direct expenses for the periods indicated by S-X 3-05 and S-X 8-04, as applicable.

2065.6 Abbreviated Financial Statements – Statement of Revenues and Direct Expenses – *General Requirements*

The staff would expect the statement of revenues and direct expenses to exclude only those costs not directly involved in the revenue producing activity, such as corporate overhead, interest and taxes. All costs directly associated with producing revenues reflected in the statement, including, but not limited to all related costs of sales and other selling, general and administrative, distribution, marketing, and research and development costs, must be included in the statement. The statement should include a reasonable allocation of expenses incurred by the seller on behalf of the business sold. The reasons for omitting any historical corporate overhead, interest, or tax expense should be explained in a note to the statements. If the type and historical amounts of these omitted expenses are known or reasonably available on an unaudited basis, they should be disclosed in an unaudited footnote. An explanation of the impracticability of preparing the full financial statements required by Regulation S-X should be provided. Also, the notes should describe how the financial statements presented are not indicative of the financial condition or results of operations of the acquired business going forward because of the omission of various operating expenses.

2065.8 Cash Flows

When abbreviated financial statements are presented, preparation of full statements of cash flows may not be practicable. However, registrants are required to provide information about the business's operating, investing and financing cash flows, to the extent available, in the notes to the financial statements or in unaudited supplemental disclosures.

2.4 Pro forma financial information

In connection with a spin-off transaction, the registrant may need to include autonomous entity adjustments in the pro forma financial information presented in its initial registration statement. Such presentation may be necessary to reflect the operations and financial position of the registrant as an autonomous entity [S-X Rule 11-01(a)(7)].

The SEC staff has noted that changes in costs evidenced by agreements, such as lease agreements or transition service arrangements, will ordinarily qualify to be autonomous entity adjustments. However, other changes in costs not evidenced by agreements will ordinarily not be autonomous entity adjustments and could instead represent synergies or dis-synergies resulting from the transaction, which the registrant may have the option to present as management's adjustments.

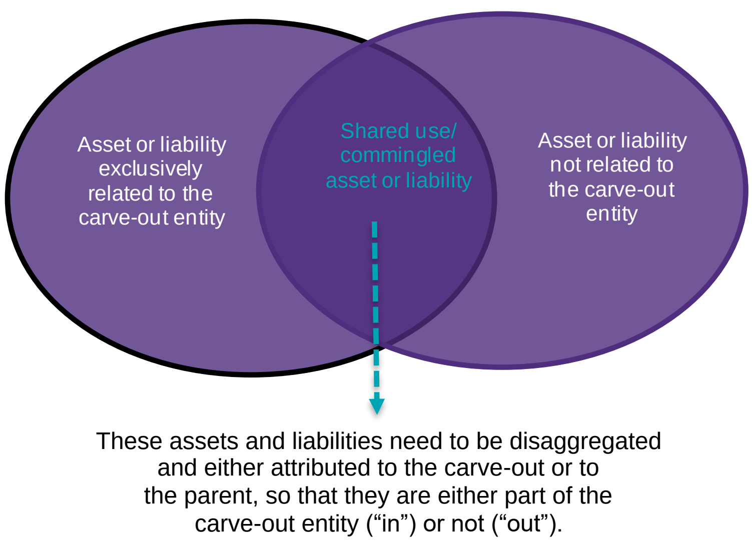
3. Assets and liabilities

When preparing carve-out financial statements, one of the most critical steps is determining which assets and liabilities are attributable to the carve-out entity. This process involves deciding whether each asset or liability is *entirely* attributable to the carve-out entity, as partial allocations are generally inappropriate. In cases where assets and liabilities are shared or commingled between the carve-out entity and the parent, further analysis is required. Management must consider factors such as the extent of usage, legal ownership, and whether the asset or liability will transfer with the carve-out entity in a divestiture. Overall, the process of attributing assets and liabilities to a carve-out entity requires significant judgment and a thorough understanding of the entity's operations and financial relationships.

3.1 Assets and liabilities general approach

Considering which assets and liabilities relate to the carve-out entity is a key step in preparing carve-out financial statements. Generally, it is inappropriate to allocate only part or a portion of a single asset or liability to a carve-out entity. As a result, assets and liabilities are generally said to form part of the carve-out entity ("in") or are excluded from the carve-out entity ("out"). For instance, it would not be appropriate to allocate 50 percent of a building to the carve-out entity. When there are shared or commingled assets and liabilities, then further disaggregation may be necessary to determine whether to attribute each asset or liability to the carve-out entity or to the parent entity.

Figure 1: Attribution of assets and liabilities to a carve-out entity



As represented in the diagram above, some assets and liabilities are clearly related to the carve-out entity, while others are clearly not related. In other cases, an asset or liability may not be exclusively used by the carve-out entity, and significant judgment may be required when determining whether to attribute these assets or liabilities to the carve-out entity. For example, a vehicle may be used by both the carve-out entity and the parent, but the carve-out cannot split a vehicle into portions for accounting purposes. As a result, the vehicle is either "in" or "out" of the carve-out entity.

3.2 Factors to consider when attributing assets and liabilities

To determine attribution of assets and liabilities to the carve-out entity, management may consider the following factors:

- The extent to which the carve-out entity utilized the asset or incurred the liability;
- The entity that holds title to the asset or bears the legal responsibility to settle the liability; and
- Whether the asset or liability will transfer with the carve-out entity in the event of a divestiture.

In the next section, the application of these factors is discussed for specific balance sheet line items.

Shared assets that are ultimately not attributed to the carve-out entity need to be considered from an income statement perspective. As discussed in SAB Topic 1.B.1, in order for financial statements to be representationally faithful, they need to reflect the full costs of doing business in the historical periods.

If an asset used by both the carve-out entity and the parent is determined not to be an asset of the carve-out entity, a usage charge should be allocated to the carve-out entity that best reflects its use of the asset, determined by applying a reasonable and supportable methodology in accordance with SAB Topic 1.B.1 (refer to Section 4.3, "Allocating shared expenses"). The usage charge should not include an imputed margin, as it should represent an allocation of the actual historical cost. An imputed margin is not calculated because carve-out financial statements are based on the attribution of actual historical activity. Accordingly, pro forma adjustments would not be included in historical carve-out financial statements.

In contrast, if the asset is legally owned by or wholly attributable to the carve-out entity, the entity would record the asset and related depreciation in the carve-out financial statements.

Further challenges could arise in attributing commingled assets or liabilities. For example, a parent entity may not have historically tracked whether accounts payable were liabilities related to the carve-out entity. It can be a time-consuming and, in some cases, labor-intensive task to determine if the assets or liabilities belong to the carve-out entity, which may require identifying details or characteristics that may not have been captured by accounting records or processes historically. See Section 3.5, "Accounts receivable and accounts payable," for further discussion of what to do in these circumstances.

3.3 Cash

Cash often remains at the parent level, especially in situations where cash is centrally managed, unless cash is held in a bank account legally owned and ultimately controlled by the carve-out entity. If using the legal entity approach as the basis of the carve-out, the cash held in a carve-out entity bank account would be included in the carve-out entity's financial statements because, under the legal entity approach, the main determinant is which entity legally owns the asset.

Restricted cash would be reflected by the cave-out entity in its financial statements if held in a bank account legally owned and ultimately controlled by the carve-out entity. Any restricted cash related to the carve-out entity's operations and agreements should be recognized in its financial statements along with appropriate disclosures. For example, restricted cash deposits held as compensating balances collateralizing short-term borrowing arrangements should be attributed to the carve-out entity if the debt represents an obligation of the carve-out entity.

ASC 210-10-45-4 (excerpt)

The concept of the nature of current assets contemplates the exclusion from that classification of such resources as the following:

a. Cash and claims to cash that are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets or are segregated for the liquidation of long-term debts. Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes shall also, under this concept, be excluded from current assets. However, if such funds are considered to offset maturing debt that has properly been set up as a current liability, they may be included within the current asset classification.

S-X 5-02 Balance sheets (excerpt)

1. *Cash and cash items.* Separate disclosure shall be made of the cash and cash items which are restricted as to withdrawal or usage. The provisions of any restrictions shall be described in a note to the financial statements. Restrictions may include legally restricted deposits held as compensating balances against short-term borrowing arrangements, contracts entered into with others, or company statements of intention with regard to particular deposits; however, time deposits and short-term certificates of deposit are not generally included in legally restricted deposits. In cases where compensating balance arrangements exist but are not agreements which legally restrict the use of cash amounts shown on the balance sheet, describe in the notes to the financial statements these arrangements and the amount involved, if determinable, for the most recent audited balance sheet required and for any subsequent unaudited balance sheet required in the notes to the financial statements. Compensating balances that are maintained under an agreement to assure future credit availability shall be disclosed in the notes to the financial statements along with the amount and terms of such agreement.

If a centralized cash pool is legally held by a related entity or the parent, none of the centralized cash should be included as cash or cash equivalents in the carve-out financial statements. If the carve-out entity owes or is owed a portion of the cash balance held in the centralized bank account(s), this amount creates a related-party balance with the affiliated entity (called an *intercompany receivable or payable*). In a centralized cash management system (such as a sweep account), the carve-out entity may hold no cash, and the sweep account may be legally controlled by the parent. Refer to Section 3.18, “Intercompany balances and intercompany debt,” for further discussion on intercompany relationships.

A cash flow statement is presented in full carve-out financial statements even if there is no cash reported on the carve-out entity’s balance sheets.

3.4 Prepaid assets

Prepaid expense assets are recorded in the carve-out entity’s financial statements to the extent the prepaid asset is attributable to the carve-out entity. However, it is common, given their nature, that some prepaid expenses are purchased centrally by the parent for more than just the carve-out entity (for example, insurance prepaid expenses covering multiple entities). Depending on facts and circumstances it might not always be possible to disaggregate a centralized prepaid asset to attribute a component to the carve-out entity. In such a situation, no asset would be recorded in the carve-out entity’s balance sheet, but a portion of such costs may be allocated to the carve-out entity and recorded as an expense in the carve-out’s income statement.

3.5 Accounts receivable and accounts payable

Accounts receivable and accounts payable attributable to the carve-out entity should be recorded in the carve-out entity’s balance sheet at the transaction level. For example, if accounts receivable were generated from revenue attributable to the operations of the carve-out entity, these accounts receivable balances would be recorded as an asset in the carve-out entity’s balance sheet. Likewise, accounts payable that are created by the carve-out entity’s operations would be included in the carve-out financial statements.

If accounts receivable and accounts payable balances are commingled (for example, an invoice includes multiple charges for different transactions), the attribution of accounts receivable and payable balances can be challenging and complex. Management should review invoices issued or received at the transaction level to properly determine the amounts to be attributed to the carve-out entity. This review may entail an inspection of individual invoices to identify those that were generated from the carve-out entity’s revenue transactions, including an inspection of individual vendor invoices to identify purchases that were made by, or on behalf of, the carve-out entity. Management may have to use specific identifiers or apply judgment to determine whether individual components within a larger balance are attributable to the carve-out entity. Identifiers that may be used to attribute commingled accounts receivable balances at the transaction level include, but are not limited to, profit centers, customers, product lines or categories, and stockkeeping units (SKUs). Accounts payable attribution may be discernable by cost center or similar identifiers, or may be based upon the nature of the goods or services received or on the address(es) where the goods were shipped or services were rendered. Determining the cost center(s) associated with a particular invoice typically involves reviewing the expense or asset account(s) to which the payable relates.

Attributing historical accounts receivable and payables

Company X is a manufacturing company with multiple divisions (Divisions A, B, C, and D) and many product lines. A division, in this instance, is part of Company X and not a separate legal entity. Company X is selling Division A, which is comprised of multiple product lines. Carve-out financial statements of Division A have been requested by a potential buyer.

The accounts receivable subledger for Company X is not disaggregated by division. As a result, Company X analyzes transaction-level information to identify which historical accounts receivable balances should be attributed to the carve-out entity. It is expected that all accounts receivable and accounts payable that relate to Division A will be sold to the potential buyer. Division A sells specific product lines to customers that also purchase goods from other divisions.

Company X also has a shared service function for purchases. Purchasing and the accounts payable subledger are commingled.

Accounts receivable

Company X analyzes customer invoices to identify specific receivables that relate to the carve-out entity. Company X examines its customer invoices line-by-line, tracking the product number and customer name associated with each invoice line item. Using the assistance of these identifiers, Company X determines the customer invoices that are wholly attributable to the carve-out entity and assigns the corresponding receivables accordingly.

For commingled invoices (for example, a single invoice used to bill a customer for products purchased from multiple divisions), management reviews the product numbers on a line-by-line basis to determine whether each invoice is partially attributed to Division A.

Accounts payable

Company X analyzes vendor invoices to identify specific payables that relate to the carve-out entity. For some vendor invoices, management clearly determines which purchase orders were requested by Division A. For other vendor invoices, purchase orders are not clearly attributable to Division A, so management reviews individual invoices for specific vendors, products, or services that are used by Division A to determine whether each invoice is attributable to Division A. Consistent with accounts receivable, management also determines whether commingled vendor invoices are wholly or partially attributable to Division A.

Company X does not attribute accounts payable for invoices that relate to a corporate shared service function to Division A. The corresponding expenses are instead allocated to the carve-out entity through a shared service/corporate management charge. Refer to Section 4.3, “Allocating shared expenses,” for more details.

3.6 Bad debt allowance, loan loss reserve, and reserve for expected credit losses

If the carve-out entity has recorded financial assets, such as accounts or loans receivable, management should consider whether an allowance for doubtful accounts or loan loss reserve is necessary. Typically, the calculation of the allowance for doubtful accounts or loan loss reserve follows the same methodology that was performed at the parent level. Only information that was known or knowable at each reporting date is used when preparing the carve-out financial statements and, therefore, hindsight would not be used when recording reserves for the carve-out entity.

Using the current expected credit loss (CECL) model in ASC 326, entities are required to present an allowance for credit losses that adjusts the amortized cost basis of the financial asset(s) such that the net carrying value represents the amount expected to be collected on the financial asset(s).

3.7 Contract assets and deferred revenue

Contract assets and contract liabilities should follow a methodology similar to that used to attribute accounts receivable and accounts payable, as described above. In other words, any amounts specifically attributable to the carve-out entity should be recorded on the carve-out entity’s balance sheet. Accordingly, accrued or deferred revenue that originates from a contract attributable to the operations of the carve-out entity should be included in the carve-out financial statements.

Commingled accrued and deferred revenue should be attributed using the same methodology used for the commingled accounts receivable and accounts payable.

3.8 Inventory

Inventory is generally specifically identifiable to a legal entity and should be attributable on that basis. Raw materials and inventory in an earlier stage of production, however, may be more challenging to attribute if using a management approach and the inventory is used by more entities than just the carve-out entity in the production process. The attribution of inventory may be complex and should be considered during the carve-out process, including, but not limited to, the allocation of intercompany profit in inventory and the inventory reserve, as discussed below.

Intercompany profit in inventory

Management must obtain an understanding of the carve-out entity’s process for manufacturing inventory in order to attribute the inventory to the carve-out entity. In many cases, the inventory costing process includes transferring inventory to and from different entities within a consolidated group, which often results in intercompany or unrealized transfer-pricing-type markups of the inventory. In accordance with ASC 810, these intercompany profits in inventory are eliminated from the consolidated financial statements. To the extent that intercompany profit in inventory is recorded from transactions between entities that make up the carve-out entity, the profit would be eliminated in the carve-out financial statements. Intercompany profit from inventory transactions with other entities of the consolidated group outside the carve-out entity, however, is not eliminated in the carve-out financial statements. Accordingly, for purchases of inventory by the carve-out entity, any profit would form part of the cost basis of the inventory; for the sale of inventory, the profit would not be eliminated in the carve-out entity’s income statement.

Inventory reserve

Pursuant to ASC 330-10-35-1B through 35-1C, inventory measured using any method other than last-in, last-out (LIFO) or the retail inventory method (for example, inventory measured using the first-in, first-out (FIFO) or the average cost method) should be measured at the lower of cost and net realizable value. Inventory measured using LIFO or the retail inventory method should be stated at the lower of cost or market value. As a result of having to potentially record inventory at below cost in accordance with

ASC 330, many companies apply a reserve to their inventories. These reserves should also be applied to the inventory reported in the carve-out financial statements generally using a methodology consistent with the parent's accounting policy. As noted previously, only information that was known or knowable at each reporting date is used when preparing the carve-out financial statements and, therefore, hindsight would not be used when recording reserves for the carve-out entity.

3.9 Long-lived tangible assets

Long-lived tangible assets include, but are not limited to, the following items:

- Buildings
- Land
- Machinery
- Fixtures and fittings
- Vehicles
- Equipment

As discussed in Section 3.1, "Assets and liabilities general approach," the attribution of a long-lived asset to a carve-out entity is done at the individual asset level. Management may need to use judgment to determine whether the carve-out entity should recognize the asset. If the legal entity approach is being used to circumscribe the carve-out entity, the entity with legal title to the asset is considered when attributing the asset. If the management approach is being used, then factors like purchase agreements and the extent to which the asset is used in the carve-out's operations are also considered in determining how to attribute the long-lived assets to the carve-out entity. If management determines that an asset is attributable to the carve-out entity, then a depreciation charge is generally recognized by the carve-out entity, as appropriate. However, as noted in Section 4.3, "Allocating shared expenses," if an asset is not attributed to the carve-out entity but the carve-out entity uses the asset, a usage charge is generally reflected in the income statement of the carve-out entity, in accordance with SAB Topic 1.B.1. No depreciation should be recognized for an asset unless it is recognized as an asset on the balance sheet of the carve-out entity. For example, if a machine is attributed to the carve-out entity, then this machine would be recognized on the carve-out entity's balance sheet, and the full amount of depreciation would be recorded. However, if a vehicle is not attributed to the carve-out entity, a usage charge would be recorded by the carve-out entity with no depreciation. As noted earlier, the usage charge should not include an imputed margin, as it should represent an allocation of the actual historical cost.

For any long-lived assets attributed to the carve-out entity but partially used by an entity outside the carve-out, there would be a usage charge to the other entity, which would generally be reflected as other income to the carve-out entity. This income would generally not be netted against the associated cost.

Management should consider any changes in asset usage or ownership during the historical periods presented. For instance, if an asset was predominately used by the parent of a carve-out entity until a certain date but was subsequently used predominately by the carve-out entity, the asset may be recorded as a transfer to the carve-out entity on the transfer date. The transfer would be reflected as an addition to fixed assets in the carve-out financial statements. Assuming no consideration was paid or payable for the transfer of the asset, the offsetting side of this entry would be to net parent investment (see Section 3.23, "Equity and net parent investment").

Allocating long-lived tangible assets

Example 1

Company X (parent) is a marketing agency that is selling its media production department (carve-out entity). The media production department is a portion of a legal entity. The parent and the carve-out entity operate in the same building, which covers 50,000 square feet and comprises 100 offices within the building. The parent entity has legal ownership over the building and will retain the title after the sale. The parent occupies 85 of the 100 similarly sized offices in the building, while the carve-out entity uses the remaining 15 offices.

The building is recognized in the parent's financial statements but is not attributed to the carve-out entity, since the parent has legal ownership. However, since the carve-out entity occupies a portion of the space, a portion of the building's operating expenses should be recognized in the carve-out financial statements to appropriately reflect its usage in accordance with SAB Topic 1.B.1 (refer to Section 4.3, "Allocating shared expenses"). Company X may, for example, choose to allocate expense based upon the relative square footage or the number of offices used by the carve-out entity. The usage charge should be based on a proportion of actual historical cost and should not include an imputed margin.

Example 2

Assume the same fact pattern as above, except that one year prior to closing the sale of the media production department, the parent relocates most of its offices, and the carve-out entity increases its use of the building. After the relocation date, the carve-out entity occupies 90 of the 100 similarly sized offices in the building. Additionally, Company X plans to sell the building with the sale of the media production department. Since the building is predominantly used by the carve-out entity after the relocation date and is expected to be sold with the carve-out entity, Company X transfers the building asset to the books of the carve-out entity as of the relocation date. The building has a carrying value of $500,000 as of the relocation date. Further, assume that there is no transfer (or expectation of transfer) of consideration from the carve-out entity to account for. As a result, as of the relocation date, the carve-out entity recognizes the building at $500,000, with an offsetting amount recorded to equity in net parent investment. Following the relocation date, expenses related to the buildings, including depreciation, will be fully recorded by the carve-out entity.

If historical carve-out financial statements are needed for a reporting period longer than one year, the carve-out entity would record an expense representing a usage charge for periods presented prior to the relocation date. The usage charge should be based on a proportion of actual historical cost and should not include an imputed margin. After the relocation date, at which time the asset transfers to the carve-out entity and is recognized on its balance sheet, expenses related to the buildings, including depreciation, are directly recorded in the carve-out entity's income statement. The income statement impact of the expenses are partially offset by usage income (that is, without an imputed mark-up) recognized by the carve-out entity as other income, reflecting the 10 percent of the building that continues to be utilized by the parent.

3.10 Leases – Lessees

Under ASC 842, a lessee initially recognizes a lease liability at the present value of the remaining lease payments along with a right-of-use (ROU) asset. The subsequent accounting varies, based on whether the lease is classified as a *finance lease* or an *operating lease*, as follows:

- *Finance leases:* A lessee adjusts the lease liability each reporting period by increasing the liability to reflect interest expense recognized and reducing the liability for any lease payments made. The ROU asset in a finance lease is measured each period at cost, less accumulated amortization and, if applicable, impairment.
- *Operating leases:* The lease liability associated with an operating lease is subsequently measured each period at the present value of the lease payments that are not yet paid. The ROU asset under an operating lease is subsequently measured based on the same methodology used for its initial measurement, unless the asset is impaired. A lessee recognizes the cost of an operating lease on a straight-line basis, taking into account any impairment or other adjustments to the ROU asset.

Refer to Grant Thornton's *Leases: Navigating the Guidance in ASC 842* for further details.

A lessee must consider whether operating lease liabilities and corresponding assets should be attributed to the carve-out entity and recorded on its balance sheet, consistent with other long-lived tangible assets and finance leases. Judgment may be required to make this determination. All relevant facts and circumstances should be considered, including, but not limited to, whether the leased asset will transfer with the carve-out entity, which entity is the legal obligor of the lease payments, and how the carve-out uses the leased asset in its operations.

Consistent with long-lived tangible assets, if the lease liability and ROU asset are not attributed to the carve-out entity but the leased asset is used, in part, by the carve-out, a usage charge should be recorded in the income statement of the carve-out entity in compliance with SAB Topic 1.B (see Section 4.3, "Allocating shared expenses").

3.11 Long-lived assets impairment

Under ASC 360, an impairment loss for a long-lived asset should be recognized if the carrying amount of the asset is not recoverable and exceeds its fair value. An impairment loss should be measured as the amount by which the carrying amount of a long-lived asset (or an asset group) exceeds its fair value. ASC 360-10-35-21 provides the following examples of events or changes in circumstances that indicate when the carrying value of a long-lived asset may not be recoverable:

- A significant decrease in the market price of an asset
- A significant adverse change in the extent or manner in which an asset is being used or in its physical condition
- A significant adverse change in legal factors or in the business climate that could affect the value of an asset, including an adverse action or assessment by a regulator
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of an asset
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses, or a projection or forecast that indicates continuing losses associated with the use of an asset

- A current expectation that an asset will more likely than not be sold or otherwise disposed of significantly before the end of its previously estimated useful life

Generally, long-lived assets that are impaired at the consolidated level should also be impaired at the carve-out level if attributed to the carve-out entity, because long-lived assets tested for impairment are grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of other assets and liabilities. Similarly, if an asset is recoverable at the consolidated level, it is likely that the asset is recoverable at the carve-out level as well. However, it is possible that the carve-out entity may identify a different asset group for impairment testing than the consolidated entity, in which case, the conclusion may differ for the carve-out entity. The undiscounted estimated future cash flows used to evaluate the recoverability of the asset group should be based on information available at the historical impairment testing date.

Long-lived asset impairment testing

Company X is a manufacturing company that owns a large manufacturing facility with an aggregate carrying value of $2,000,000. Company X tested the manufacturing facility for impairment in aggregate after identifying the entire manufacturing facility as an asset group, because this was the lowest level for which identifiable cash flows were largely independent of other assets and liabilities. No impairment was indicated since the estimated undiscounted cash flows exceeded the carrying value of the asset group.

Company X enters into a transaction to sell one of its businesses, a sale that will include a portion of the manufacturing facility's assets, requiring carve-out financial statements. Company X identifies that $1,200,000 of the carrying amount of the manufacturing facility's assets will be retained, while $800,000 of the carrying amount of the assets will transfer in the sale and should be attributed to the carve-out entity. Therefore, the $800,000 carrying amount of assets attributed to the carve-out entity will be grouped at the lowest level for which identifiable cash flows are largely independent of other assets and liabilities, and an impairment analysis will be conducted separately for the carve-out entity.

	Carve-out assets	Aggregate
Carrying value of assets	$800,000	$2,000,000
Fair value of assets	$500,000	$1,500,000
Undiscounted estimated cash flows	$700,000	$2,200,000
Impairment loss	$300,000	$ -

The aggregate assets historically held by the parent entity were recoverable, even though their fair value is less than their carrying value, because the undiscounted future cash flows are greater than the carrying amount of the assets; therefore, no impairment loss is recorded.

However, the historical manufacturing facility's assets attributed to the carve-out entity are not recoverable because the carrying value exceeds the fair value of the assets and the sum of the undiscounted future cash flows is less than their carrying value. Therefore, an impairment loss of $300,000 (the difference between the carrying amount and the fair value of the asset group) is recorded in the historical carve-out financial statements.

3.12 Goodwill

Generally, if the carve-out entity represents the entirety of a single reporting unit of the parent entity, then the entire goodwill balance of that reporting unit is assigned to the carve-out entity. In contrast, if the carve-out entity meets the definition of a "business" and comprises only a portion of a reporting unit or portions of multiple reporting units under the parent, the amount of goodwill allocated to each reporting unit should be determined in a reasonable and supportable manner.

In theory, goodwill should be attributed to the carve-out entity based on the amount that would have been recognized by the carve-out entity at the time of acquisition. This task becomes particularly challenging when multiple acquisitions have occurred over an extended period. For instance, goodwill may not have been allocated historically between the carve-out entity and the parent for each acquisition when determining the goodwill to assign to the parent's historical reporting units, as that level of disaggregation was not necessary at the time. Accordingly, professional judgment may be required to determine how to best attribute acquisition-generated goodwill to a carve-out entity. If the carve-out represents only a portion of a previously acquired business, the parent should apply a rational and reasonable method to allocate the appropriate portion of the goodwill from the acquired business to the carve-out. Generally, the relative fair value allocation approach should be used (referenced in ASC 350-20-35 below), whereby goodwill is allocated to the carve-out entity based upon the fair value of the business included in the carve-out entity compared to the fair value of the aggregate business(es) acquired as of the acquisition date. The allocation of goodwill may be further complicated if the carve-out entity includes portions of multiple previous acquisitions transacted by the parent. Further, in certain situations, a parent may have been reorganized, resulting in segment changes that lead to new reporting units. As a result, goodwill pertaining to the carve-out entity may be challenging to reconstruct, or the valuation work conducted at the time of the original acquisition(s) may not include adequate detail.

ASC 350-20-35-45

When an entity reorganizes its reporting structure in a manner that changes the composition of one or more of its reporting units, the guidance in paragraphs 350-20-35-39 through 35-40 shall be used to reassign assets and liabilities to the reporting units affected. However, goodwill shall be reassigned to the reporting units affected using a relative fair value allocation approach similar to that used when a portion of a reporting unit is to be disposed of (see paragraphs 350-20-40-1 through 40-7).

ASC 350-20-35-46

For example, if existing reporting unit A is to be integrated with reporting units B, C, and D, goodwill in reporting unit A would be assigned to units B, C, and D based on the relative fair values of the three portions of reporting unit A prior to those portions being integrated with reporting units B, C, and D.

Identifying reporting units

Once management has determined the amount of goodwill attributable to the carve-out entity, it would then need to further allocate this goodwill to the reporting units of the carve-out entity. In order to attribute goodwill to the reporting units of the carve-out entity, the carve-out must first determine its reporting units, which may differ from those determined for the parent entity.

The high-level steps in identifying the reporting units of the carve-out entity are as follows:

1. Identify the operating segments of the carve-out entity;
2. Determine if each operating segment represents a single reporting unit or if each operating segment comprises multiple reporting units; and
3. Attribute goodwill to the reporting units.

The carve-out entity should identify operating segments by applying the guidance in ASC 280, which is intended to provide a view of the entity through the eyes of management. The carve-out entity determines the identity of the chief operating decision maker (CODM) and ascertains how information is organized for the CODM to assess the company's performance and to make decisions about resource allocation.

ASC 280 defines an "operating segment" as a component of an entity having all of the following characteristics:

- The component engages in business activities that may generate revenue and incur expenses, including revenue and expenses relating to transactions with other components of the same entity.
- The component's operating results are regularly reviewed by the CODM to make decisions about allocating resources to the segment and assessing the segment's performance.
- There is discrete financial information available for the component.

Once all operating segments have been identified, management must determine whether each operating segment is a single reporting unit or comprises several reporting units. As defined in ASC 280, a reporting unit is considered a component of an operating segment if both (1) the component constitutes a business for which discrete financial information is available, and (2) segment management regularly reviews the component's operating results. ASC 280 requires that two or more components of an operating segment should be aggregated and deemed a single reporting unit if they have similar economic characteristics.

Once the reporting units have been identified and the goodwill attributable to the carve-out entity has been allocated to those reporting units, the entity can then perform subsequent goodwill impairment testing.

For more information on determining operating segments and reporting units, see Grant Thornton's *Segment reporting: More than just disclosure* and *Impairment: Indefinite-lived intangibles and goodwill.*

Potential difference between goodwill derecognized by the parent and goodwill included in the carve-out

The amount of goodwill recorded by the carve-out entity may differ from the amount of goodwill the parent entity derecognizes in its financial statements upon divestiture of the carve-out entity. This situation may occur when the parent entity attributes a portion of goodwill from an acquisition to synergies of the combined entity and therefore assigns a portion of goodwill from the acquired business to another existing reporting unit.

Difference between goodwill derecognized by the parent and goodwill included in the carve-out

A parent company has two reporting units, RU1 and RU2, which have goodwill balances of $20 and $30, respectively. The parent then acquires Business A, which generates $50 of goodwill, and assigns Business A to RU1. The parent determines that synergies from the Business A acquisition will also benefit RU2 and assigns $10 of the Business A goodwill to RU2. After the Business A acquisition, RU1 has goodwill of $60 ($20 + $40), and RU2 has goodwill of $40 ($30 + $10).

Subsequently, the parent company decides to sell a component of Business A (which resides in RU1), and carve-out financial statements are created for the component. The historical goodwill amount of $50 generated from the acquisition of Business A is included in the fair-value allocation between the carve-out entity and the component of Business A being retained, regardless of the fact that $10 of that goodwill is allocated to RU2. The carve-out entity is reporting from the perspective of a standalone entity, and the standalone historical goodwill generated from the acquisition of Business A is $50. For its consolidated financial statements, the parent performs a relative fair-value allocation of goodwill at the date of disposal. This allocation includes $40 of goodwill reported in RU1. The $10 of goodwill in RU2 from the Business A acquisition is not derecognized with the sale but is still evaluated for impairment.

3.12.1 Goodwill impairment

After goodwill has been attributed to the carve-out entity and assigned to its reporting units, management must test the goodwill for impairment at the reporting unit level, according to ASC 350. Reporting unit goodwill should be tested for impairment annually or more frequently if events or circumstances occur that would more likely than not reduce the fair value of the reporting unit below its carrying amount.

ASC 350-20-35-28

Goodwill of a reporting unit shall be tested for impairment on an annual basis and between annual tests in certain circumstances (see paragraph 350-20-35-30). The annual goodwill impairment test may be performed any time during the fiscal year provided the test is performed at the same time every year. Different reporting units may be tested for impairment at different times.

ASC 350-20-35-30

Goodwill of a reporting unit shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Paragraph 350-20-35-3C(a) through (g) includes examples of such events and circumstances. Paragraphs 350-20-35-3F through 35-3G describe the process for making these evaluations.

In practice there are two approaches related to goodwill impairment testing for a carve-out entity:

1. Goodwill was previously tested by the parent for impairment in each of the historical periods presented, and the results of such testing are "passed down" to any goodwill attributed to the carve-out entity. If the testing performed by the parent results in no impairment charge, then the carve-out entity need not record any impairment charge or perform further retrospective impairment testing. This view is consistent with the lack of explicit requirements under U.S. GAAP to retest goodwill retrospectively for a reorganization of reporting units. Although an entity would generally be expected to test goodwill for impairment immediately before and after a reorganization or any other event that results in a change in an entity's reporting units, such expectation would not require retesting of historical periods prior to the change. This point of view results in the most efficient and cost-effective approach to impairment testing for a carve-out entity.

2. Once goodwill has been attributed to the carve-out entity, it must be retrospectively tested for impairment at the opening balance-sheet date and at least annually thereafter, which may lead to recognizing an impairment charge in an historical period that was not recognized by the parent entity. This view derives its logic from ASC 350-20-35-48 (see excerpt below), which states that goodwill should be tested for impairment at the subsidiary level in any separate financial statements. In other words, the subsidiary tests goodwill for impairment as though the subsidiary were a standalone entity—that is, reporting units for purposes of testing goodwill for impairment, as well as the goodwill impairment that is recognized, are determined based on the subsidiary being a standalone entity. When this guidance is applied by analogy to a carve-out entity, it results in the carve-out entity testing goodwill separately as if it were a stand-alone entity historically. This is a more time consuming and expensive approach, but it provides greater assurance that the carve-out financial statements will include any impairment charges necessary to present the carve-out entity as if it were a standalone entity.

ASC 350-20-35-48

All goodwill recognized by a public or nonpublic subsidiary (subsidiary goodwill) in its separate financial statements that are prepared in accordance with generally accepted accounting principles (GAAP) shall be accounted for in accordance with this Subtopic. Subsidiary goodwill shall be tested for impairment at the subsidiary level using the subsidiary's reporting units. If a goodwill impairment loss is recognized at the subsidiary level, goodwill of the reporting unit or units (at the higher consolidated level) in which the subsidiary's reporting unit with impaired goodwill resides must be tested for impairment if the event that gave rise to the loss at the subsidiary level would more likely than not reduce the fair value of the reporting unit (at the higher consolidated level) below its carrying amount (see paragraph 350-20-35-3C (f)). Only if goodwill of that higher-level reporting unit is impaired would a goodwill impairment loss be recognized at the consolidated level.

Since there is no specific authoritative literature on impairment testing of goodwill for carve-out financial statements resulting in diversity in practice, management should consider all relevant facts and circumstances when planning an approach.

3.13 Intangible assets (other than goodwill)

Intangible assets recorded on the consolidated entity's books should be evaluated to determine whether any intangible assets are attributable to the carve-out entity. It can be challenging to attribute an intangible asset between the carve-out entity and a related entity because the benefits of an intangible asset can be shared (for instance, a tradename may be used by the carve-out entity and other entities). Generally, the determination of whether to attribute the intangible asset to the carve-out entity should include consideration of who owns legal title to the asset, whether the asset will transfer with the carve-out upon disposition, and to what extent the asset is used in the carve-out's operations.

Consistent with other long-lived assets, if the carve-out entity uses a finite-lived intangible asset but does not record this asset in its balance sheet, it may still be appropriate to record a usage charge for the asset in the carve-out income statement.

Finite-lived intangible asset

Company X is a pharmaceutical company (parent) that is selling its cancer research department (carve-out entity). Company X has a 20-year patent over one of the technologies used by both the parent entity and the carve-out entity. The parent possesses legal ownership of the patent and will retain this ownership after the transaction. Since the parent retains legal ownership of the patent, the patent would not be attributed to the carve-out entity. However, since the carve-out entity obtained benefits from the patent prior to the sale, it would be appropriate for the carve-out entity to recognize an expense in its historical financial statements using a reasonable allocation methodology to reflect its usage of the patent, as prescribed by SAB Topic 1.B.1 (refer to Section 4.3, "Allocating shared expenses").

Indefinite-lived intangible assets should be attributed to the carve-out entity in a similar manner. However, since indefinite-lived intangible assets are not amortized but are instead tested for impairment, the carve-out entity would not record a charge for using intangible assets that are not attributed to it, unless a fee was historically charged to the carve-out entity for that usage.

3.13.1 Intangible assets impairment

Finite-lived intangible assets are tested for impairment under ASC 360, consistent with tangible long-lived assets (see Section 3.9, "Long-lived tangible assets").

Impairment testing for indefinite-lived intangible assets is performed at the "unit of account" level in accordance with ASC 350-30-35-21 through 35-28. This guidance provides that separately recorded indefinite-lived intangible assets should be combined into a single unit of account for purposes of testing impairment if the assets operate as a single asset and are essentially inseparable from one another. Management must determine whether the indefinite-lived intangible assets assigned to the carve-out entity have a unit of account that differs from the parent entity's unit of account. If the unit of account for the indefinite-lived intangible asset of the carve-out entity and the parent entity is determined to be the same, the carve-out entity does not need to separately test the asset for impairment, since the parent's test may be applied to the carve-out entity. In this case, any impairment charge determined at the parent level is attributed to the carve-out financial statements. Alternatively, once the intangible has been attributed to the carve-out entity, it must be retrospectively tested for impairment at the opening balance-sheet date and at least annually thereafter.

However, if the unit of account of the carve-out entity differs from that of the parent entity, management must test the indefinite-lived intangible asset assigned to the carve-out entity for impairment separately. The unit of account of the carve-out entity would differ if some, but not all, of the indefinite-lived intangible assets assigned to a unit of account at the parent level are attributed to the carve-out entity.

Indefinite-lived intangible assets impairment

Company X groups two indefinite-life intangibles (A and B) into one unit of account for impairment testing purposes. Intangibles A and B were originally acquired for $100,000 and $200,000, respectively. Company X's impairment testing resulted in no impairment charge since the aggregate fair value of the assets was determined to be $350,000, which is greater than the assets' aggregate carrying value of $300,000.

Intangible B is being sold as part of a transaction that requires carve-out financial statements and has been attributed to the carve-out entity. Since the unit of account at the carve-out entity differs from the parent's, the impairment test for Intangible B on its own should be re-performed for the carve-out financial statements.

Intangible B has a carrying value of $200,000 and a fair value of $180,000. A $20,000 impairment charge is recognized in the financial statements of the carve-out entity, even though the parent did not historically record an impairment charge.

For more information on impairment, see Grant Thornton's *Impairment: Indefinite-lived intangibles and goodwill*.

3.14 Debt

Generally, a carve-out entity applies the guidance from ASC 805 by analogy when attributing debt for the carve-out financial statements. According to ASC 805-50-30, an acquiree should 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 U.S. GAAP.

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.

In other words, the carve-out entity should recognize debt in its financial statements only if the debt represents an obligation of the carve-out entity. In addition, if using the management approach, debt would be recorded in the carve-out financial statements if a parent entity is legally responsible for the settlement of third-party debt related to the historical operations of the carve-out entity, but the carve-out entity will assume this debt upon divestiture. In this situation, expenses associated with the debt (such as interest expense or deferred financing fee amortization) would also be reflected in the carve-out financial statements.

Outstanding debt that was extinguished during a historical reporting period would be reflected as debt of the carve-out entity under the legal entity approach, provided it was historically an obligation of the legal entity. Under the management approach, management would need to assess the extent to which the carve-out entity utilized or incurred the debt.

If the carve-out entity guarantees the parent's debt or enters into a joint and several liability arrangement with the parent, the debt instrument may need to be recorded in the carve-out financial statements, subject to the recognition and measurement guidance in ASC 460 or in ASC 405-40.

ASC 460-10-30-2

Except as indicated in paragraphs 460-10-30-3 through 30-5, the objective of the initial measurement of a guarantee liability is the fair value of the guarantee at its inception.

ASC 405-40-15-1

For the total amount of an obligation under an arrangement to be considered fixed at the reporting date there can be no measurement uncertainty at the reporting date relating to the total amount of the obligation within the scope of this Subtopic. However, the total amount of the obligation may change subsequently because of factors that are unrelated to measurement uncertainty. For example, the amount may be fixed at the reporting date but change in future periods because an additional amount was borrowed under a line of credit for which an entity is jointly and severally liable or because the interest rate on a joint and several liability arrangement changed.

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.

3.15 Derivatives and hedges

Derivative instruments issued by a carve-out entity's parent should be evaluated to determine whether they are attributable to the carve-out entity. Particular consideration should be given to derivatives designated as hedging instruments. If the underlying item that an instrument is hedging against is attributed to the carve-out entity, then the hedging instrument should be attributed to the carve-out entity as well. The accounting followed by the parent is typically followed by the carve-out entity for derivative instruments attributed to the carve-out entity. For example, changes in the fair value of an instrument attributable to the carve-out entity that were previously recognized in accumulated other comprehensive income (AOCI) in the parent's consolidated financial statements would also be included in the carve-out financial statements.

For instruments issued by the parent that relate to the operations of both the carve-out entity and related entities, the derivative instrument would typically not be attributed to the carve-out entity and, accordingly, would not be recorded in the carve-out balance sheet. However, management should consider whether to allocate a portion of the related income statement activity to the carve-out entity.

3.16 Intercompany balances and intercompany debt

Any intercompany balances between the carve-out entity and the parent are eliminated in the consolidated financial statements but are included in the carve-out financial statements because carve-out financial statements are prepared as though the carve-out entity had been operating on a standalone basis. Intercompany balances between entities within the carve-out entity should continue to be eliminated in carve-out financial statements.

Management must determine the manner in which to settle the intercompany receivables and payables that are not eliminated in the carve-out financial statements. Intercompany receivables and payables with the parent should be recorded as an asset or a liability on the carve-out balance sheet if an obligation to cash settle with parent cash is expected. Such assets and liabilities are typically separately presented on the face of the balance sheet labeled as "Due from (to) related party." If an intercompany balance is expected to be forgiven, it is recorded in equity as part of net parent investment (NPI), as it effectively represents a contribution from, or distribution to, the parent.

Determination of which intercompany balances should be eliminated from the carve-out financial statements can be complex in situations with significant commingled activity (refer to Section 3.5, "Accounts receivable and accounts payable," for examples of commingled third-party invoices). Management should consider how it will make sure that intercompany balances and transactions are complete.

Disclosure of intercompany balances and transactions is required in the related-party footnote to the carve-out financial statements.

Intercompany balances

Company X has entered into a transaction to sell Division A, which requires carve-out financial statements. Company X had purchased $5 million of goods from Division A at cost in the prior fiscal year. No cash was exchanged in the transaction, and an intercompany receivable was recorded in the ledger of Division A.

When preparing the carve-out financial statements, management must determine whether the receivable will be either settled or forgiven in the future. This determination may not have been made previously, since the intercompany balances were eliminated in the consolidated financial statements of Company X.

If cash settlement is expected, the $5 million intercompany receivable will remain on the balance sheet of the carve-out financial statements of Division A and will be labeled as "Due from related party" on the face of the balance sheet.

If forgiveness is expected, the $5 million receivable will be reclassified as NPI in equity.

Regardless of the settlement conclusion, the related-party footnote in the carve-out financial statements should disclose the nature of the $5 million intercompany transaction, the classification of related amounts, and the fact that the transaction did not occur at arm's length.

If the carve-out entity uses proceeds from its parent's debt to fund its operation, the debt is considered to be intercompany debt. Similar to intercompany payables, intercompany debt shared with the parent should be recorded as a liability on the carve-out balance sheet if the carve-out entity is obligated to pay back the parent. If not, the balance of debt is recorded in equity as part of the net parent investment equity line in the carve-out entity's financial statements.

The SEC bulletin below provides guidance on accounting for interest expense on intercompany debt.

ASC 220-10-S99-3 (codified SAB Topic 1.B.1)

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 the 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.

In the SEC interpretation above, the carve-out entity would not record interest expense on debt from the parent in its income statement if such a charge had not been provided in the past and the related debt liability is not recorded by the carve-out entity. This is a deviation from the normal usage charge concept and alleviates the complexity of imputing a reasonable interest expense charge. However, if the debt is specifically related to the carve-out's historical operations and is recorded in the carve-out entity's financial statements, the related interest expense should be recorded in the carve-out entity's income statement. Additionally, a footnote disclosure is required to describe the intercompany financing arrangement with the parent, regardless of whether interest charges for the intercompany debt are recorded in the carve-out entity's income statement.

3.17 Commitments and contingencies

Commitments and contingencies (for example, environmental or legal contingent liabilities or guarantees) should be recorded in the carve-out financial statements if the carve-out entity is the primary obligor. Management should determine whether to attribute a commitment or contingency to the carve-out entity if the commitment or contingency relates to the carve-out entity's operations and will be assumed by the carve-out entity post-transaction, even if the carve-out entity is not the primary obligor. When commitments and contingencies are attributed to the carve-out entity, any related impact on the carve-out's income statement should also be reflected in the carve-out financial statements.

If the parent is the primary obligor for a contingency and will retain this obligation post-transaction, but the contingency relates wholly or partially to the carve-out entity's historical operations, the contingency would generally not be attributed to the carve-out entity. However, management should consider whether allocating any related expense would be appropriate to reflect the costs of doing business, as directed by SAB Topic 1.B.1 (refer to Section 4.3, "Allocating shared expenses").

If the carve-out entity guarantees any obligations of the parent or enters into a joint and several liability arrangement with the parent, a liability may need to be recorded in the carve-out financial statements, subject to the recognition and measurement guidance in ASC 460 or in ASC 405-40.

Commitments and contingencies

Company K has three subsidiaries—J, D, and L—each of which was involved in the provision of engineering services to a customer. Company K's services caused damages to the customer's property, prompting the customer to commence legal proceedings against Company K.

Subsidiary D is being spun off and requires carve-out financial statements. Company K has accrued a liability for a potential settlement in its consolidated financial statements. The damages could not be directly attributed to just one of the subsidiaries. Company K is the primary obligor for the legal case, and any liability resulting from the case is incumbent on the parent.

Subsidiary D will not reflect a settlement liability in the carve-out financial statements since it is not the primary obligor and will not assume the liability post-transaction. However, management may allocate a portion of the related expense pertaining to the settlement liability to Subsidiary D.

3.18 Accrued liabilities

Accrued liabilities that are attributable to the carve-out entity should be recognized in the carve-out financial statements. If accruals relate to both the carve-out entity and related entities, additional analysis may be necessary to determine whether these general accruals can be attributed in part to the carve-out entity.

Employee-related costs, such as salaries, wages, and vacation accruals, are often attributable to the carve-out entity based on specifically identifiable attributes, such as which entity employs the individual to which an accrual relates. Some accruals may not be specifically identifiable to the carve-out entity, however, and additional analysis may be necessary to determine attribution. When the employee-related costs are attributed to the carve-out entity, the employee-related accrual and the corresponding expense should be recorded in the carve-out financial statements. While employee-related accruals are not partially allocated to a carve-out entity, an individual employee's expense may be allocated between the carve-out entity and the parent, with either a resulting charge or partial offset to employee-related expenses in the carve-out financial statements.

Accrued liability for employee-related costs and property accruals

Company X has entered into a transaction to divest Division Y, requiring carve-out financial statements for Division Y. Employee Z has a salary of $120,000 and spends 75% of her time performing duties for the carve-out entity and 25% of her time performing duties for the parent entity. Employee Z will transfer with Division Y as part of the transaction. Management initially attributes Employee Z's full payroll cost and accrual to the carve-out entity, on the basis that Employee Z spends the majority of her time performing work for Division Y and, as part of the transaction, will transfer with Division Y. At the end of the year, the payroll accrual for Employee Z is $12,000.

Management determines that the relevant driver for Employee Z's payroll cost is the time that she spends performing duties for the carve-out entity as a percentage of total working hours. Since Employee Z spends 25% of her time performing duties for Company X (the parent entity), in the carve-out financial statements of Division Y, management allocates $30,000 of salary expense to the parent entity. Accordingly, salary expense is reduced by $30,000, and an offsetting entry is recorded to NPI since no refund is expected for the employee expense related to the parent. Subsidiary's Y salary accrual is not impacted by the allocation.

Similarly, property accruals are attributed to Division Y based on whether they are specifically identifiable to the carve-out entity. For example, if the property is recorded by the carve-out entity, then the accruals would be recorded by the carve-out entity. On the other hand, if the property is a shared corporate building that is not recorded by the carve-out entity, no property accruals would typically be attributed to the carve-out entity, and no accrual would be recognized in the carve-out financial statements. A management allocation to reflect a usage charge for the property would be recognized in the income statement of the carve-out entity in this case.

The relevant principles outlined in this section should be applied to other types of accrued liabilities.

3.19 Workers' compensation and other self-insurance accruals

Entities that self-insure for workers' compensation claims or other types of claims are required to record related liabilities based on both known claims and incurred-but-not-reported (IBNR) claims. Liabilities for known claims, particularly for employee-related self-insurance programs like workers' compensation, may be attributable to a carve-out entity based upon the specific identification of the employee claimant or other claim data. Liabilities for IBNR claims, however, are often more difficult to attribute because they are typically based upon actuarial projections that may not be segregated between the carve-out entity and other components of the larger entity. Such liabilities may be allocated to the carve-out entity based upon a suitable driver, such as relative payroll or headcount, for employee-related claims.

3.20 Defined benefit plan assets/liabilities

The carve-out entity's employees may participate in a defined benefit plan sponsored by the parent entity, the carve-out entity, or another entity within the consolidated group. If the carve-out entity has its own defined benefit plan, then single-employer plan accounting applies, and the carve-out financial statements would reflect the accounting for the full plan in accordance with ASC 715. A single-employer plan is a pension plan or other postretirement benefit plan that is maintained by one employer. Accordingly, these carve-out financial statements would reflect the benefit obligation liability, plan assets, and AOCI amounts of the defined benefit plan in addition to the income statement components. Refer to Section 4.7, "Defined benefit plans," for income statement considerations.

If the parent entity sponsors the plan and the carve-out entity constitutes a subsidiary of the parent, however, the carve-out entity would account for the defined benefit plan as a participation in a multiemployer plan, in accordance with ASC 715-30-55-62 through 55-64.

In many cases, the parent entity sponsors a multiemployer benefit plan, but the carve-out entity does not constitute a subsidiary of the larger entity. The approach to accounting for a defined benefit plan requires judgment when employees of the carve-out entity are part of a plan held by the parent. We are aware of two approaches currently being used in practice that apply in this situation: the *multiemployer approach* and the *allocation approach*.

Multiemployer approach

A characteristic of *multiemployer plans* is that assets contributed by one participating employer may be used to provide benefits to employees of other participating employers, because assets contributed by an employer are not segregated in a separate account or restricted to providing benefits only to employees of that employer. This contrasts with a *multiple-employer plan* that maintains separate accounts for each employer so that contributions provide benefits only for employees of the contributing employer.

Under the multiemployer plan approach to account for these benefit plans in the carve-out financial statements, assets and liabilities are not recorded on the individual participating employer's balance sheets, except that a liability may be recognized for any contributions due and unpaid (if applicable).

ASC 715-30-55-62

Subtopic 715-80 provides guidance on multiemployer plans. Paragraph 715-30-35-70 provides guidance on multiple-employer plans that distinguishes multiemployer from multiple-employer plans and requires that multiple-employer plans be viewed as in-substance aggregations of single-employer plans. The following example illustrates the guidance in that paragraph.

ASC 715-30-55-63

Assume a not-for-profit entity (NFP) has a defined benefit pension plan that covers employees at the national and all local chapters and each chapter is required to contribute to the pension plan based on a predetermined formula (for example, on a percentage-of-salary basis), plan assets are not segregated or restricted on a chapter-by-chapter basis, and if a chapter withdraws from the pension plan, the pension obligations for its employees are retained by the pension plan as opposed to being allocated to the withdrawing chapter. This arrangement should be accounted for as a single-employer pension plan in the NFP's financial statements. However, in each chapter's separate financial statements (if issued) the arrangement should be accounted for as a multiemployer pension plan. It is unclear how an allocation of net periodic pension cost or the overfunded or underfunded status of the defined benefit pension plan would be made if each chapter were to view its respective participation as a single-employer pension plan because the assets are not segregated or restricted by chapter and obligations are not assumed by a withdrawing chapter. Accounting for the pension plan as a multiemployer pension plan requires that a chapter's contribution for the period (in this example, the amount required to be contributed to the pension plan based on a percentage of its employees' salaries) be recognized as net periodic pension cost. A liability would be recognized for any contributions due and unpaid. The disclosures required by Section 715-80-50 do not apply in this situation. Instead, each chapter should disclose the name of the plan in which it participates and the amount of contributions it made in each annual period for which a statement of income (statement of activities for not-for-profit entities) is presented, as well as any related-party disclosures required by Subtopic 850-10.

ASC 715-30-55-64

The conclusions in the preceding paragraph would also be true in a similar parent-subsidiary arrangement if the subsidiaries issue separate financial statements. In a similar arrangement, each subsidiary should account for its participation in the overall single-employer pension plan as a participation in a multiemployer pension plan. The disclosures required by Section 715-80-50 do not apply in this situation. Instead, each subsidiary should disclose the name of the plan in which it participates and the amount of contributions the subsidiary made in each period for which a statement of income or statement of activities is presented. The parent entity should, of course, account for the pension plan as a single-employer pension plan in its consolidated financial statements.

Allocation approach

Under the allocation approach, an entity essentially carves out the related assets, liabilities, and income statement/other comprehensive income from the parent's pension plan and accounts for the carve-out as a separate plan sponsored by the carve-out entity. This approach effectively treats the portion of the defined benefit plan related to the carve-out entity as a single-employer plan. The allocation approach is not frequently used in practice, but it may be appropriate if a plan obligation of the parent is transferred along with the carve-out entity.

3.21 Equity and NPI

Net parent investment represents the parent's interest in the recorded net assets of the carve-out entity. A carve-out entity using the management approach has no defined capital structure, and NPI is therefore treated as a component of changes in equity in the carve-out financial statements. The changes in the equity statement include the beginning NPI balance, transactions with the parent, income or loss attributable to the carve-out entity's operations, and the ending NPI balance.

The allocation of shared costs will not result in the transfer of assets between the carve-out entity and the parent; accordingly, the offsetting debit or credit is recorded in NPI in the carve-out financial statements as an increase or a decrease in contributed capital from the parent. As a general rule, if there is no settlement of the intercompany transaction and the net assets of the carve-out entity increase, the transaction is considered to be a contribution to the carve-out entity from the parent. Conversely, if there is no settlement and the net assets of the carve-out entity decrease, the transaction is accounted for as a distribution from the carve-out entity to the parent. For example, the carve-out entity may record an expense in its income statement and a credit to NPI to reflect costs for shared employees that are not attributed to the carve-out entity, which were previously recorded at the parent level and are not expected to be reimbursed.

In contrast, when cash settlement is expected between the parent and the carve-out entity, an asset or liability is recorded on the carve-out balance sheet, designated as a receivable or payable to an affiliate or a related party.

Example NPI rollforward shown in the statement of changes in equity section of full carve-out financial statements

	Total NPI
	$'000
Balance at December 31, 20X1	$120,000
Net loss	(20,000)
Net contributions from Parent	50,000
Balance at December 31, 20X2	150,000
Net income	60,000

Net distributions to Parent	(20,000)
Balance at December 31, 20X3	**$190,000**

Other equity accounts, such as AOCI or noncontrolling interest, are typically disclosed separately in the statement of change in equity.

If the carve-out entity consolidates a foreign component, the carve-out applies ASC 830 to quantify the appropriate cumulative translation adjustments (CTA) for each reporting period from the inception of the carve-out. Calculating the opening balance-sheet CTA can be particularly challenging for carve-out entities with several years of activity. Accordingly, in certain circumstances, the carve-out may allocate CTA at the opening balance-sheet date utilizing a reasonable allocation method. In subsequent periods, CTA would be calculated for each reporting period in accordance with ASC 830.

4. Income statement

Carve-out financial statements should reflect the revenue and expenses of the carve-out entity. Expenses of the carve-out entity may also encompass expenses incurred by the parent on behalf of the carve-out entity that are not currently reflected in the financial records of the entity being carved out. Consequently, these expenses should be allocated to the carve-out entity, with limited exceptions, such as when preparing abbreviated financial statements.

4.1 Revenue

Revenue of the carve-out entity should be reflected in the carve-out financial statements. There are many ways that a company may track revenue in the accounting system, such as by using product codes, customer codes, invoices, and customer contracts. Revenue is usually disaggregated in this manner and can then be identified and attributed to the carve-out entity. However, if clear identifiers are not available, determining revenue for the carve-out entity may be complex and would require judgment.

Entities should also consider the disclosures required by ASC 606 when attributing revenue to a carve-out entity. For example, the carve-out entity may be required to disaggregate revenue into categories differently compared to its parent company due to differences in materiality.

ASC 606-10-50-5

An entity shall disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. An entity shall apply the guidance in paragraphs 606-10-55-89 through 55-91 when selecting the categories to use to disaggregate revenue.

ASC 606-10-50-6

In addition, an entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with paragraph 606-10-50-5) and revenue information that is disclosed for each reportable segment, if the entity applies Topic 280 on segment reporting.

ASC 606-10-55-91

Examples of categories that might be appropriate include, but are not limited to, all of the following:

a. Type of good or service (for example, major product lines)

b. Geographical region (for example, country or region)

c. Market or type of customer (for example, government and nongovernment customers)

d. Type of contract (for example, fixed-price and time-and-materials contracts)

e. Contract duration (for example, short-term and long-term contracts)

f. Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)

g. Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

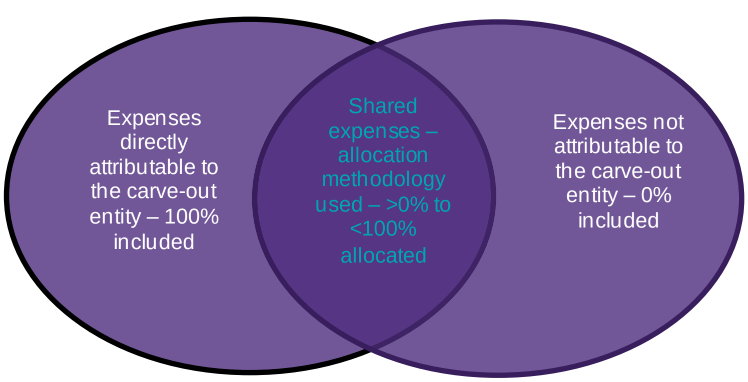
4.2 Expenses

The SEC stated in SAB Topic 1.B.1 that carve-out financial statements, except for abbreviated carve-out financial statements that include only direct expenses (see Section 2.3.5, "Abbreviated financial statements"), should reflect all expenses of doing business. The full expenses of doing business may include expenses incurred by the parent that are not currently reflected in the financial records of the entity being carved out. Accordingly, these expenses should be allocated to the carve-out entity. The SEC gives the following examples of expenses to consider allocating to a carve-out entity in its income statement:

1. Officer and employee salaries
2. Rent or depreciation
3. Advertising
4. Accounting and legal services
5. Other selling, general, and administrative expenses

This list is not exhaustive, and judgment may be required in determining which expenses should be allocated to the carve-out entity to reflect the full costs of doing business.

Figure 2: Attribution of expenses to a carve-out entity



If expenses are attributable to a carve-out entity, these expenses should be recorded in full in the carve-out financial statements. For example, the salaries of employees that work directly with and exclusively for the carve-out entity should be recorded entirely in the carve-out financial statements. Expenses not directly related to a carve-out entity should not be allocated to the carve-out, such as the occupancy costs of a building not used by the carve-out entity. Shared expenses should be allocated based on a reasonable and supportable allocation methodology.

4.3 Allocating shared expenses

For each type of shared expense, it is essential that management carefully determine the most suitable cost driver for allocating expenses to the carve-out entity. The selected driver for each expense or category of expenses should accurately reflect the proportion of the expense attributable to the carve-out entity, thereby ensuring that the income statements accurately reflect all expenses of doing business for the carve-out entity, consistent with SAB Topic 1.B.1. For instance, corporate employee expenses may be allocated to the carve-out entity based upon relative time spent on the carve-out entity. Likewise, occupancy costs pertaining to parent-owned corporate buildings partially used by the carve-out entity may be allocated based upon the relative square footage used by each entity. The key is to be able to allocate expenses in a manner that best reflects the carve-out entity's utilization of resources or services as it operates under the parent entity.

Corporate employee expenses

Company A has entered a transaction to divest Division B, requiring carve-out financial statements for Division B. Corporate Employee C has a salary of $100,000 and spends 25% of his time performing duties for the carve-out entity and 75% of his time performing duties for the other parts of Company A.

Management determines that the relevant driver for Corporate Employee C payroll cost is the time that Corporate Employee C spends performing duties for the carve-out entity as a percentage of total working hours. Since Corporate Employee C spends 25% of his time performing duties for Division B, management allocates $25,000 of salary expense to Division B. An offsetting entry is recorded to NPI since no refund is expected for the employee expense related to the parent.

Some companies, for internal reporting purposes, already allocate centralized expenses to subsidiaries, divisions, or business units using a "management charge." Often, these management charges are based on a simplistic allocation methodology that may not best reflect the appropriate allocation driver for each type of expense. It is important to assess whether the management charge allocation methodology is reasonable and supportable and whether it accurately reflects expenses attributable to the carve-out entity.

For example, all centralized expenses incurred by the parent may be allocated to subsidiaries based upon the relative amount of revenue each subsidiary generates, but this method may not reflect the most appropriate allocation basis for all expenses. It may be more appropriate to allocate rent based on the square footage used by the carve-out entity rather than by attributing a proportion of revenue, as the former better reflects utilization. This difference in allocation could lead to a material misstatement of allocated expenses, which may occur for an individual cost or due to an aggregation of improperly allocated expenses. If there is a material difference between the current management allocation and a reasonable and supportable methodology of allocation, it would be appropriate to reverse the management charges and to record a supportable revised expensed allocation. It is important for the carve-out entity to report a fully burdened income statement—that is, to present all the expenses of doing business in the carve-out financial statements as if it were a standalone entity, including expenses that were incurred by the parent.

It is crucial for the preparer of the carve-out financial statements to establish a complete population of potential expenses that are relevant to the carve-out entity and to document the cost allocation rationale for each type of expense. This process would also be required as audit support if the carve-out financial statements are subject to audit. Furthermore, the total and relative allocation bases should be supported by documentation. For example, a data analytics company may allocate information technology expenses using a percentage of server time. However, this metric may be challenging to support in a financial statement audit because server time is a metric unlikely to be subject to an entity's internal controls over financial reporting (ICFR). If the carve-out financial statements are subject to audit, management and the audit team are encouraged to hold early discussions in areas requiring the use of judgment, such as expense allocations.

Example allocation methodology

The following table provides an example of an allocation methodology. This example is purely an illustration, and the sample allocation base is not appropriate for all situations, as there may be a more appropriate driver that best reflects the usage for the specific carve-out business being analyzed.

Example allocation methods		
Example	**Example allocation driver (pro-rata)**	**Example rationale**
Auto insurance – Parent pays insurance for 100 vehicles, including insurance for 25 vehicles that are used by the carve-out entity. All vehicles are used for similar purposes and are operated in a similar location.	Value of vehicles	Vehicle value primarily drives auto insurance premiums, as location and usage of the vehicles is similar; therefore, total insurance expense could be pro-rated based on relative vehicle value. Accordingly, insurance expense is allocated by the relative value of the 25 vehicles used by the carve-out entity.
Rent – Carve-out entity uses 500 square feet (25%) of a corporate office building that consists of 2,000 square feet	Square footage	Square footage occupied indicates relative level of usage of the shared office. Accordingly, total rent for the office building could be pro-rated to burden the

Example allocation methods		
Example	**Example allocation driver (pro-rata)**	**Example rationale**
		carve-out entity with 25% of the corporate office rent.
Learning and development (L&D) expenses – Parent provides a series of training course to all employees, including those of the carve-out entity.	Employee headcount	Relative employee headcount that attended the courses could be used to pro-rate the total expenses of the training course and allocate a portion to the carve-out entity.
Sales software expense – Parent has a software used by sales representatives across all businesses of Parent, including those of the carve-out business. Parent's businesses are in a mature phase, and therefore sales efforts are distributed evenly across all businesses by relative size.	Revenue for a sales-related software/subscription	Level of revenue could be used to indicate relative usage of the sales software by each business of the Parent. Accordingly, the sales software expense is allocated to the carve-out entity by relative revenue.

ASC 220-10-S99-3 (codified SAB Topic 1.B.1)

Facts: A company (the registrant) operates as a subsidiary of another company (parent). Certain expenses incurred by the parent on behalf of the subsidiary have not been charged to the subsidiary in the past.

Question 1: Should the subsidiary's historical income statements reflect all of the expenses that the parent incurred on its behalf?

Interpretive Response: In general, the staff believes that the historical income statements of a registrant should reflect all of its costs of doing business. Therefore, in specific situations, the staff has required the subsidiary to revise its financial statements to include certain expenses incurred by the parent on its behalf. Examples of such expenses may include, but are not necessarily limited to, the following (income taxes and interest are discussed separately below):

1. Officer and employee salaries,

2. Rent or depreciation,
3. Advertising,
4. Accounting and legal services, and
5. Other selling, general and administrative expenses.

When the subsidiary's financial statements have been previously reported on by independent accountants and have been used other than for internal purposes, the staff has accepted a presentation that shows income before tax as previously reported, followed by adjustments for expenses not previously allocated, income taxes, and adjusted net income.

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

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

In addition, since agreements with related parties are by definition not at arm's 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.

The following example provides sample language that can be used for disclosures in a set of full carve-out financial statements. The disclosures describe the nature of the corporate expense allocation, the types of expenses being allocated, the drivers used for the allocations, and the amounts that were allocated. The example also includes a disclosure that indicates the reported expenses may not be representative of actual expenses incurred had the entity been operating on a standalone basis.

Example disclosure language for full carve-out financial statements related to the allocation of corporate expenses

Allocation of corporate expenses

The expenses of certain services that are provided by the Parent to the Carve-out Entity have been reflected in these financial statements, including allocations for certain centralized administration expenses for treasury, real estate, accounting, auditing, tax, risk management, human resources, and benefits administration. These allocations of centralized administration expenses were determined using a proportional cost allocation method on the basis that the Carve-out Entity and the Parent considered to be reasonable, including relative operating profit, fixed assets, sales, and payroll. Allocated expenses are included in the "Selling, general, and administrative expenses" line of the combined and consolidated statements of income. The total amount allocated for centralized administration expenses by the Parent in 20X1, 20X2, and 20X3 were $[.], $[.], and $[.], respectively. These expenses represent management's reasonable allocation of the expenses incurred. However, these amounts may not be representative of the expenses necessary for the Carve-out Entity to operate as a separate standalone company. The "Net parent investment" line item in the combined and consolidated statements of equity primarily reflects dividends paid to Parent and expenses paid by the Parent on behalf of the Carve-out Entity.

4.4 Intercompany transactions

Consistent with intercompany balances, intercompany transactions are eliminated in consolidated financial statements, but are included in the carve-out financial statements for transactions between a carve-out entity and its parent. Intercompany transactions among entities that form part of the carve-out entity are eliminated in the carve-out financial statements.

Identifying intercompany transactions between the parent entity and the carve-out entity should include the consideration of a corporate overhead expense allocation.

In some cases, a long-lived asset attributed to the carve-out entity may be partially utilized by another entity in the consolidated group. Although the expense of the asset (for example, depreciation) should be reflected in the carve-out financial statements, generally the usage by the parent may be recorded as other income by the carve-out entity if it is a long-lived asset. The usage charge should not include an imputed margin, as it should represent an allocation of the actual historical cost.

The particular facts and circumstances should be considered when determining the classification of the usage charge, such as whether leasing is the main business operation of the carve-out entity. When shared assets are physical, the carve-out entity should also assess the historical terms of the arrangement to determine whether it is party to a leasing arrangement under ASC 842 with the related entity.

Disclosure of the intercompany transactions that are not eliminated in the carve-out financial statements should be made in the related-party footnote.

4.5 Employee compensation

Similar to employee-related accruals (see Section 3.20, “Accrued liabilities”), employee-related expenses are generally attributed to the carve-out entity at the level of the individual employee. If an employee provides services to the carve-out entity, either a portion or all of the employee’s compensation expense should be allocated to the carve-out entity. Often, an employee may provide services to both the parent entity and the carve-out entity (for example, a member of the parent’s corporate staff who also supports the carve-out entity). In these cases, only a portion of the employee’s expenses is allocated to the carve-out entity, using a reasonable and supportable allocation method.

Time tracking of individual employees may provide the most accurate way of allocating an individual employee’s expense between the carve-out entity and the parent. However, if time is not tracked in sufficient detail, management should identify another appropriate driver to allocate the related expense between the parent and carve-out entity. Relevant drivers may include the following:

- Estimated time spent working for the carve-out entity as a percentage of total hours worked (must be practically determinable and supportable);
- Revenue as a percentage of total revenue (may be relevant for sales employee or certain corporate employees); and
- Headcount as a percentage of total headcount (may be relevant for corporate HR professionals).

The selected allocation driver should be the one that best reflects the usage of each employee’s or employee group’s time and is likely to vary by type of employee.

Allocating employee compensation

Company X is a large retailer that is selling the sporting goods component (carve-out entity) of its business. Company X has 1,000 employees, 100 of which are dedicated solely to the sporting goods component. Additionally, there are 20 employees in corporate functions that spend a portion of their time working on the sporting goods component. Company X has determined that these 20 employees spend less than half of their time working on the sporting goods component, and these employees are not attributed in full to the carve-out entity.

The carve-out entity records all of the compensation expense (and corresponding accruals) related to the 100 employees that are solely dedicated to the sporting goods component. In addition, the compensation expense for the 20 shared employees will be partially allocated to the carve-out entity. The allocation methodology used should best reflect the carve-out entity’s usage of each employee’s time, consistent with the principles outlined in SAB 1.B.1 (refer to Section 4.3, “Allocating shared expenses”). If Company X does not have a time tracking system, management must adopt a method to appropriately allocate the proportion of total expense of an individual shared employees to the carve-out entity.

4.6 Share-based payment awards

Share-based payment awards (stock compensation) should be attributed to the carve-out entity by individual employee, consistent with other forms of employee compensation expenses. If an employee has provided services to the carve-out entity, any share-based payments awarded to the employee should be reflected in the carve-out financial statements. If an employee only spends a portion of his or her time providing services to the carve-out entity, then management should develop a reasonable and consistent allocation method to distribute a portion of any share-based awards to the carve-out entity. Refer to Section 4.5, "Employee compensation," for an example of how to allocate shared employee compensation expenses.

If the carve-out entity includes a legal entity that operates its own stock compensation plan, the disclosures required under ASC 718 should be reflected in the footnotes to the carve-out financial statements. If employees are wholly attributable to the carve-out entity and participate in the parent's stock compensation plan, the relevant disclosures in ASC 718 should be included in the carve-out financial statements. However, the ASC 718 disclosures are not applicable for employees that are not wholly attributable to the entity and for whom only a portion of their compensation expense is allocated to the carve-out entity through a corporate allocation. These allocated expenses may simply form part of the overall expense allocation disclosures.

If a share-based payment award that is granted to an employee who is attributed to the carve-out entity is modified, the carve-out entity should account for the modification in accordance with ASC 718.

Example of share-based compensation disclosure for stock compensation that is a corporate allocation in carve-out financial statements

The parent maintains stock compensation plans for the benefit of certain officers, directors, and employees, including grants of employee stock options, purchases under employee stock purchase plans, and restricted awards. These financial statements include certain expenses of the parent that were allocated to the carve-out business for stock-based compensation. The stock-based compensation expense is recognized over the requisite service period, based on the grant-date fair value of the awards and the number of the awards expected to be vested based on service and performance conditions, net of forfeitures. The carve-out business's balance sheets do not include any of the parent's outstanding equity related to these stock-based compensation programs. We recorded any tax effect related to stock-based awards in the statements of operations.

For more information on accounting for stock compensation plans, see Grant Thornton's *Share-based payments: Navigating the guidance in ASC 718*.

4.7 Defined benefit plans

Depending upon the balance sheet carve-out approach selected for the defined benefit plans (see Section 3.22, "Defined benefit plans assets/liabilities"), the approach to the income statement will have differing financial statement impacts.

For a carve-out entity associated with a single employer plan or one where management has selected the allocation approach, the financial reporting impact to the carve-out entity's income statement/other comprehensive income is calculated following the guidance for a single employer plan in ASC 715.

For those carve-out entities applying the multiemployer approach to the parent's defined benefit plan, an expense should be recognized for the amount that the carve-out entity contributes to the defined benefit plan in each period for each participant that is attributed to the carve-out entity. For shared employees, the carve-out entity should allocate the net periodic pension cost utilizing a reasonable allocation method consistent with SAB 1.B.1.

4.8 Transaction costs and restructuring costs

Management should determine whether transaction costs (for example, accounting, legal, and banking fees) are attributable to the carve-out entity. This may require significant judgment and is typically based on evaluating which entity benefits most from the expenses being incurred. Any such expenses attributed to the carve-out entity are recognized in accordance with applicable U.S. GAAP.

Similar to transaction costs, restructuring costs should be attributed to the carve-out entity if they are associated with the historical operations of the carve-out entity.

Transaction costs in the carve-out financial statements

Company X has recently completed a transaction to sell Subsidiary A, which requires the preparation of carve-out financial statements. Advisory fees were incurred for sell-side due diligence related to the sale. Since sell-side due diligence services likely benefited the parent rather than the carve-out entity (or acquirer), the advisory fees would not be included in the carve-out financial statements.

5. Tax

There can be significant complexities when determining taxes for a carve-out entity. The structure of the carve-out is crucial to understand before calculating a tax provision. This section provides an overview of some tax considerations when preparing carve-out financial statements.

5.1 Income statement approach

The legal structure of the carve-out entity is important when determining the amount of current and deferred taxes to present in the carve-out financial statements. Under the management approach, carve-out entities often comprise components of legal entities (for example, a product line is carved out of a parent or a division is spun off) so that historically, a separate income tax return has rarely been prepared for the carve-out entity. In instances where the carve-out entity has not historically filed a tax return, it will typically employ a separate return method to compute income tax amounts. This entails calculating current and deferred provisions, as well as deferred tax assets and liabilities, as if the carve-out entity were a standalone tax return filer. The separate return method is based on the pre-tax income statement and balance sheet of the carve-out entity, inclusive of all carve-out adjustments (for example, allocations). Current and deferred tax expenses and deferred tax balances are then calculated and included in the carve-out financial statements in accordance with the principles outlined in ASC 740-10-30-27.

If a historical tax sharing arrangement was in place during the reporting periods presented in the carve-out financial statements, any differences between the tax expense or benefit calculated using the separate return approach and those calculated using the tax sharing arrangement are recognized as balances due to or from the parent, or as equity transactions, depending on the specific facts and circumstances (see Section 3.18, “Intercompany balances and intercompany debt”).

ASC 740-10-30-27

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. This Subtopic does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Subtopic. A method that allocates current and deferred taxes to members of the group by applying this Topic to each member as if it were a separate taxpayer meets those criteria. In that situation, the sum of the amounts allocated to individual members of the group may not equal the consolidated amount. That may also be the result when there are intra-entity transactions between members of the group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

ASC 740-10-30-28

Examples of methods that are not consistent with the broad principles established by this Subtopic include the following:

a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences

b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Subtopic (for example, the deferred method that was used before 1989)

c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense

ASC 740-10-30-27 requires entities to allocate the consolidated current and deferred tax expense among the legal entities included in the consolidation if those legal entities issue separate financial statements. However, it does not prescribe a specific allocation methodology. As long as the allocation method is systematic, rational, and consistent with the broad principles in ASC 740, it is acceptable. ASC 740-10-30-28 provides examples of allocation methods that would not be consistent with the principles in ASC 740. The most common method for allocating the current and deferred taxes to a carve-out entity is the separate return method, which is the recommendation of the SEC in SAB Topic 1.B.1.

ASC 220-10-S99-3 (codified SAB Topic 1.B.1)

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.

In SAB Topic 1.B.1 above, the SEC states that a separate return method is preferable—that is, the calculation of current and deferred provisions should be done as though the carve-out entity is a standalone filer. Further, in SAB Topic 1.B.1 above, when a different allocation method is used, the SEC requires a pro forma income statement for the most recent fiscal year and interim period reflecting a tax provision calculated on a separate return basis.

5.2 Balance-sheet approach

Differences between the tax basis and financial statement amounts of assets and liabilities reported in the carve-out financial statements result in deferred tax assets and liabilities in those financial statements. The deferred tax assets and liabilities recorded will depend on which underlying assets and liabilities have been attributed to, and recorded in, the carve-out financial statements. Additionally, deferred tax assets are recognized for any tax attributes, such as tax loss carryforwards or tax credits, that are expected to be inherited by the carve-out entity based on the nature of the anticipated transaction.

If the carve-out entity is a taxpaying entity, an income tax payable or receivable is reflected in the carve-out financial statements. If the carve-out entity is not a taxpaying entity, an income tax payable or receivable is typically not reflected in its financial statements, as the carve-out entity is not the legal obligor. Instead, these amounts may be reflected as a payable/receivable to the taxpaying entity under a tax-sharing agreement or as an equity transaction.

The carve-out entity should recognize a valuation allowance if it is unlikely (technically, if the “more likely than not” threshold is not met) that it will realize all or a portion of the deferred tax asset. The evaluation is based on the information available at the historical assessment date, without hindsight. As a result, the carve-out entity may reach a different conclusion than the parent on whether to realize historical deferred tax assets. Additionally, the carve-out entity would typically not revisit other historical assertions made for the consolidated group using hindsight. For example, assumptions or assertions related to the indefinite reinvestment of foreign earnings under ASC 740-30-25-17 generally would not be revisited in the historical carve-out financial statements. Similarly, conclusions reached on uncertain tax positions related to the carve-out entity would generally not be revisited.

6. Other considerations

This section discusses some other financial reporting considerations when preparing carve-out financial statements.

6.1 Statement of cash flows

A statement of cash flows that reports both an entity's financial position and the results of its operations is required in all financial statements, including a set of carve-out financial statements. The statement of cash flows may be omitted when an entity prepares abbreviated financial statements if it is impracticable to prepare a cash flow statement.

The preparation of a statement of cash flows for a carve-out entity is generally similar to that of its consolidated parent entity since the operations of the carve-out entity are part of the consolidated entity. Management should first prepare the carve-out entity's balance sheets and income statement, and then use that financial data to prepare the cash flow statement for the carve-out entity, a process that is consistent with preparing the consolidated statement of cash flows.

While cash flows arising from intercompany transactions between entities in the carve-out entity are eliminated in the carve-out's cash flow statement, cash flows generated from intercompany transactions between the carve-out entity and the parent should not be eliminated in the carve-out's statement of cash flows. Management should refer to the guidance in ASC 230 related to the classification of intercompany transactions within the operating, investing, or financing sections of the statement of cash flows.

In many cases, the parent entity holds and manages cash centrally, so that the carve-out entity does not present any cash on its balance sheet. For these carve-out entities, the due to/from parent account is akin to its cash account, and changes in this account effectively reflect cash flows that should be disclosed in its statement of cash flows.

6.2 Discontinued operations

ASC 205-20 provides guidance on whether the disposal of a business should be presented as a discontinued operation in the financial statements. A discontinued operation is triggered when all of the following criteria are met:

1. The disposal group is a component of an entity;
2. The disposal group meets the held-for-sale criteria in ASC 205, or the group is actually disposed of either by sale or a transaction other than sale in accordance with ASC 360; and
3. The disposal represents a "strategic shift," as defined in ASC 205.

ASC 205-20-45-1A

A discontinued operation may include a component of an entity or a group of components of an entity, or a business or nonprofit activity.

ASC 205-20-45-1B

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

a. The component of an entity or group of components of an entity meets the criteria in paragraph 205-20-45-1E to be classified as held for sale.

b. The component of an entity or group of components of an entity is disposed of by sale.

c. The component of an entity or group of components of an entity is disposed of other than by sale in accordance with paragraph 360-10-45-15 (for example, by abandonment or in a distribution to owners in a spinoff).

ASC 205-20-45-1C

Examples of a strategic shift that has (or will have) a major effect on an entity's operations and financial results could include a disposal of a major geographical area, a major line of business, a major equity method investment, or other major parts of an entity (see paragraphs 205-20-55-83 through 55-101 for Examples).

ASC 205-20-45-1E

A component of an entity or a group of components of an entity, or a business or nonprofit activity (the entity to be sold), shall be classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the authority to approve the action, commits to a plan to sell the entity to be sold.

b. The entity to be sold is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such entities to be sold. (See Examples 5 through 7 [paragraphs 360-10-55-37 through 55-42], which illustrate when that criterion would be met.)

c. An active program to locate a buyer or buyers and other actions required to complete the plan to sell the entity to be sold have been initiated.

d. The sale of the entity to be sold is probable and transfer of the entity to be sold is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 205-20-45-1G. (See Example 8 [paragraph 360-10-55-43], which illustrates when that criterion would be met.)

e. The entity to be sold is being actively marketed for sale at a price that is reasonable in relation to its current fair value. The price at which an entity to be sold is being marketed is indicative of whether the entity currently has the intent and ability to sell the entity to be sold. A market price that is reasonable in relation to fair value indicates that the entity to be sold is available for immediate sale, whereas a market price in excess of fair value indicates that the entity to be sold is not available for immediate sale.

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

The guidance in ASC 205 may require discontinued operations to be disclosed for a parent or carve-out entity as a result of selling or disposing of a component of its business. The parent entity may be required to report discontinued operations associated with a transaction that requires carve-out financial statements.

There are likely to be differences in how a discontinued operation is presented in the carve-out financial statements and the parent's discontinued operations disclosure. For instance, ASC 205-20-45-9 prohibits the allocation of general corporate overhead to discontinued operations, whereas such allocations are commonly reported in carve-out financial statements.

The carve-out entity must still consider whether the guidance in SAB Topic 5.Z.7 applies (refer to Section 1.3, "Depicting all the historical activity of an entire legal entity (application of SAB Topic 5.Z.7)"). Should the guidance in SAB Topic 5.Z.7 apply to the carve-out entity, the assets, liabilities, and activities that the carve-out entity distributed to the pre-transaction parent would have been retrospectively excluded from the historical carve-out financial statements. Consequently, considerations of discontinued operations in accordance with ASC 205-20 would be irrelevant, as the distributed assets, liabilities, and activities would not be present in the carve-out financial statements from the outset.

6.3 Segment reporting

If carve-out financial statements are being prepared for a public entity, then segment reporting under ASC 280 is applicable. Refer to Section 2, "Reporting considerations," for a more detailed discussion of differing financial reporting requirements for financials being filed with the SEC.

Segment information is not required for a Rule 3-05 filing if the acquired business is not a public entity, according to FRM Section 2005.1.

CorpFin's *Financial Reporting Manual*

2005.1

Financial statements of the acquired business are generally the same as those as if the acquired company were a registrant as described in Topic 1, except that the number of years of audited financial statements is determined by the level of significance (Section 2030 below). Refer to Sections 2045 and 2050 regarding age of financial statements.

Exceptions: An acquired business that is a nonpublic entity, as that term is defined in GAAP, need not include disclosures if specifically excluded from the scope of the FASB standard. Examples include:

- Segment information under SFAS 131 [SFAS 131, par. 9 / ASC 280-10-15-3],
- Certain disclosures about employers' pensions and other postretirement benefits [SFAS 132(R), par. 8 / ASC 715-20-50-5]
- Earnings per share under SFAS 128 [SFAS 128, par. 1 / ASC 260-10-05-1].

When segment disclosures are provided, management must identify the carve-out entity's operating and reportable segments in accordance with ASC 280.

For more information on segment reporting, download Grant Thornton's *Segment reporting: More than just disclosure*.

6.4 Subsequent events

In accordance with ASC 855-10-25-1 through 25-2, the carve-out entity is required to evaluate subsequent events that occur through the date when the financial statements are issued (for SEC filers and conduit bond obligors for conduit debt securities traded in a public market) or the date when they are available to be issued (for all other entities). The entity must determine whether any identified subsequent events constitute *recognized* subsequent events or *nonrecognized* subsequent events pursuant to ASC 855. A *recognized* subsequent event is one that provides additional evidence about conditions that existed at the balance-sheet date, including estimates inherent in the process of preparing the financial statements, which entities are required to recognize in the financial statements. A *nonrecognized* subsequent event reflects conditions that did not exist at the balance-sheet date but arose after the balance-sheet date and before the financial statements are issued or are made available to be issued. These events are not recognized in the financial statements but may require disclosure in the footnotes under ASC 855.

When considering the date through which a carve-out entity should evaluate subsequent events, many entities analogize to the reissuance guidance in ASC 855-10-25-4, which states that an entity should only disclose, and not recognize, any additional events that occur after the financial statements are initially issued, unless an adjustment is required by GAAP or regulatory requirements, generally for a correction of an error. Under this view, the subsequent cutoff dates applicable to the parent also apply to the carve-out entity when considering whether events should be recognized in the carve-out financial statements. However, if new subsequent events related to the carve-out entity are identified by management after issuing the parent's financial statements but before issuing the carve-out entity's financial statements, management should evaluate these events to determine whether they require disclosure in the carve-out financial statements. Management should also evaluate each subsequent event that relates to the carve-out entity using the carve-out entity's materiality threshold.

Entities that do not analogize to the reissuance guidance should instead consider the first issuance of the carve-out financial statements to be the initial issuance. These entities should apply both the recognition and disclosure requirements in ASC 855 through the date when the carve-out financial statements are issued or are made available to be issued, as applicable.

ASC 855-10-25-1

An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. See paragraph 855-10-55-1 for examples of recognized subsequent events.

ASC 855-10-25-1A

An entity that meets either of the following criteria shall evaluate subsequent events through the date the financial statements are issued:

a. It is an SEC filer

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

ASC 855-10-25-2

An entity that meets neither criteria in the preceding paragraph shall evaluate subsequent events through the date that the financial statements are available to be issued.

ASC 855-10-25-3

An entity shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued. See paragraph 855-10-55-2 for examples of non-recognized subsequent events.

ASC 855-10-25-4

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

6.5 Consistent accounting policies between the parent and the carve-out entity

Carve-out financial statements are derived from the parent entity's accounting records, and the accounting policies applied in the carve-out financial statements should align with those of the parent entity, unless a change in accounting policy is deemed preferable. Consequently, adopting accounting policies that differ from those of the parent entity without demonstrating preferability would be inappropriate.

As carve-out financial statements are derived from the parent's historical accounting records, ensuring that accounting policies are consistent with those of the parent entity can present challenges. This is particularly true if the carve-out entity is a smaller component of a much larger entity. For example, materiality considerations at the consolidated level may have previously permitted the carve-out entity to follow different accounting policies from the parent or even to misapply U.S. GAAP, as the differing policy or misapplication did not result in a material misstatement at the parent's financial reporting level. Due to the lower materiality threshold likely applicable to the carve-out entity's standalone financial statements, management should evaluate whether retrospective revisions to the carve-out entity's historical accounting are necessary to align them with the parent's accounting policies. For further details on materiality considerations, please refer to Section 7.4, "Materiality."

Furthermore, certain policies may have been immaterial to the consolidated parent company, but may be material to the carve-out entity, potentially requiring incremental accounting policy disclosures under ASC 235. For instance, if inventory was immaterial at the consolidated parent level, an inventory policy footnote may not have been included in the parent company's financial statements. However, if inventory is material for the carve-out entity, the footnote would be included in the carve-out financial statements.

There may be instances where the carve-out entity must adopt accounting standards that the parent entity has not yet adopted or must reverse private company accounting alternatives previously elected by the parent entity. If an entity is required to change its accounting principles (for an SEC filing, for instance), a preferability assessment is not required, as the change in accounting principle is mandatory. However, if accounting principles are changed for other reasons, the carve-out entity must establish the preferability of the new policy in accordance with ASC 250.

6.6 Differing accounting policies within the carve-out entity

A parent and a subsidiary or multiple subsidiaries may have historically applied different accounting policies under U.S. GAAP. Accordingly, if the carve-out entity consists of multiple legal entities or parts of multiple legal entities, the various components of the carve-out may have historically applied different accounting policies. For example, one component of a carve-out entity may depreciate long-lived assets using the straight-line depreciation method, while another component may use the units-of-production method of depreciation. The policies of one component of the carve-out entity do not need to match the policies of the other components of the carve-out entity if they were not matched historically between the different legal entities. However, the carve-out entity is required to disclose all of the policies used in the notes to the carve-out financial statements.

6.7 Disclosure on carve-out judgments

Financial statements, irrespective of whether they are carve-out or other financial statements, should include disclosures on significant accounting policies. This is consistent with the objectives of ASC 235, which requires a reporting entity to disclose specific accounting principles and the methods of applying those principles that management judges to be the most appropriate in fairly presenting the reporting entity's financial position, cash flows, and results of operations in the financial statements.

ASC 235-10-50-3 requires disclosures of accounting policies that materially affect the financial statements. Given the potential unique judgments involved in preparing carve-out financial statements, comprehensive disclosures regarding the basis of preparation, as well as any significant judgments involved, are typically required.

ASC 235-10-50-3

Disclosure of accounting policies shall identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure shall encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it shall encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives

b. Principles and methods peculiar to the industry in which the entity operates, even if such principles and methods are predominantly followed in that industry

c. Unusual or innovative applications of GAAP.

To comply with ASC 235, the basis of presentation footnote typically discloses, in summary form, how the carve-out financial statements are derived from the parent's historical financial statements. Additionally, due to potentially significant judgments involved in the preparation of the carve-out financial statements, the footnotes often disclose that the historical results may not be indicative of the financial position or operations of the carve-out entity if it had operated independently from the parent.

Typically, entities would also disclose in this footnote how the carve-out entity was defined, what reporting framework was used, whether the carve-out financial statements are consolidated or combined, and whether the financial statements are full or abbreviated carve-out financial statements. Other basis of presentation disclosures in practice include, but are not limited to, the nature of costs allocated, the allocation methodology applied to those costs, and a description of the presentation of equity.

The following example illustrates part of a basis of preparation disclosure with discussion around some unique carve-out judgments that have been used in the preparation of the financial statements.

Example basis of presentation disclosures for carve-out financial statements using the management approach

The financial statements are prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP), have been derived from the Parent's historical accounting records, and are presented on a carve-out basis. The financial statements are not intended to be a complete presentation and are not necessarily indicative of the financial position or results of operations that would have been achieved if the Carve-out Entity had operated as a separate, standalone entity as of or during any of the periods presented, nor are they indicative of the financial condition or results going forward.

All revenues and costs as well as assets and liabilities directly associated with the business activity of the Carve-out Entity are included in the financial statements. The income statement also includes expense allocations for certain functions historically performed by the Parent and allocated to the

Carve-out Entity. These functions primarily relate to finance and accounting, legal, information technology, human resources, communications, commercial/marketing services, engineering, environmental, regulatory compliance, health, and safety. The allocations have been determined on the basis that the Carve-out Entity considered to be reasonable reflections of the utilization of services provided by the Parent. A more detailed discussion of the relationship with the Parent, including a description of the costs that have been allocated to the Carve-out Entity as well as the method of allocation, is included in the related party footnote (Note XX). Management believes these allocations are a reasonable representation of the cost incurred for the services provided; however, these allocations may not be indicative of the actual expenses that would have been incurred had the Carve-out Entity been operating as a standalone company for the year presented.

Within these financial statements, entities that are part of the Parent's results of operations but are not part of the Carve-out Entity are referred to as "related entities."

The Carve-out Entity uses a centralized approach to cash management and financing its operations. Financial transactions relating to operations are accounted for through the net parent investment account. Accordingly, none of the Parent's cash, cash equivalents, or debt is reflected by the Carve-out Entity. The net parent investment does not represent an agreement or expectation that these amounts will be paid to or received by the Parent.

6.8 Pushdown accounting

The acquirer of a business must record the assets and liabilities of the acquired business using the acquisition method in ASC 805-20. The acquiree in a business combination, on the other hand, has the option to remeasure its assets and liabilities in its separate financial statements by adopting the acquirer's basis of accounting (that is, the acquisition method) rather than using historical cost. This option is called "pushdown accounting," a process in which the fair values of assets acquired and liabilities assumed that are reported in the consolidated statements are "pushed down" to the acquiree's financial statements. Pushdown accounting may be applied to some or all of a carve-out entity's historical transactions. The FASB defines "pushdown accounting" in the Codification's Master Glossary as follows.

Pushdown Accounting

Use of the acquirer's basis in the preparation of the acquiree's separate financial statements.

6.8.1 Pushdown accounting election

Making a pushdown election is not establishing an accounting policy; rather, it is an election made at the time of a change-in-control event before the separate financial statements are issued. A change-in-control event is when an acquirer obtains control of an acquiree. A change-in-control event for purposes of applying pushdown accounting has not occurred if one party loses control of the entity without another party gaining control. If an entity does not elect to apply pushdown accounting upon a change-in-control event, it may elect to apply pushdown accounting to its most recent change-in-control event in a subsequent reporting period as a change in accounting principle. Pushdown accounting should be applied as of the acquisition date of the change-in-control event. This election, once made, is irrevocable. However, if financial statements have never been prepared for the carve-out entity historically, pushdown accounting may be elected when preparing the carve-out financials.

It is possible to “push down” the acquirer’s basis of accounting for one acquisition but not for another. In situations where multiple subsidiaries, or portions of multiple subsidiaries, are included in a set of carve-out financial statements, the reporting entity should consider the consistency of financial information when pushdown accounting elections differ among these subsidiaries. For instance, the carve-out entity could include part of a legal entity that applied pushdown accounting and part of another entity that did not apply pushdown accounting. The carve-out entity may want to consider applying push-down accounting to all of its components to avoid creating an inconsistent basis between the components.

6.8.2 Black line presentation

An entity that elects pushdown accounting is required to present a “black line” in the historical financial statements when a change in control occurs within the historical carve-out financial statement period. A pushdown election effectively creates a new basis of accounting, which means the old reporting entity from the “predecessor period” ceases to exist, and a new reporting entity is created in a “successor period.” The black line in the financial statements splits the financial statements between the “predecessor” and “successor” periods in the carve-out’s separate financial statements.

ASC 805-50-25-4

An acquiree shall have the option to apply pushdown accounting in its separate financial statements when an acquirer—an entity or individual—obtains control of the acquiree. An acquirer might obtain control of an acquiree in a variety of ways, including any of the following:

a. By transferring cash or other assets

b. By incurring liabilities

c. By issuing equity interests

d. By providing more than one type of consideration

e. Without transferring consideration, including by contract alone as discussed in paragraph 805-10-25-11

ASC 805-50-25-5

The guidance in the General Subsections of Subtopic 810-10 on consolidation, related to determining the existence of a controlling financial interest shall be used to identify the acquirer. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs 805-10-55-11 through 55-15 shall be considered in identifying the acquirer. However, if the acquiree is a variable interest entity (VIE), the primary beneficiary of the acquiree always is the acquirer. The determination of which party, if any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of Subtopic 810-10, not by applying the guidance in the General Subsections of that Subtopic relating to a controlling financial interest or the guidance in paragraphs 805-10-55-11 through 55-15.

ASC 805-50-25-6

The option to apply pushdown accounting may be elected each time there is a change-in-control event in which an acquirer obtains control of the acquiree. An acquiree shall make an election to apply pushdown accounting before the financial statements are issued (for a Securities and Exchange Commission (SEC) filer and a conduit bond obligor for conduit debt securities that are traded in a public market) or the financial statements are available to be issued (for all other entities) for the reporting period in which the change-in-control event occurred. If the acquiree elects the option to apply pushdown accounting, it must apply the accounting as of the acquisition date.

ASC 805-50-25-7

If the acquiree does not elect to apply pushdown accounting upon a change-in-control event, it can elect to apply pushdown accounting to its most recent change-in-control event in a subsequent reporting period as a change in accounting principle in accordance with Topic 250 on accounting changes and error corrections. Pushdown accounting shall be applied as of the acquisition date of the change-in-control event.

ASC 805-50-25-8

Any subsidiary of an acquiree also is eligible to make an election to apply pushdown accounting to its separate financial statements in accordance with the guidance in paragraphs 805-50-25-4 through 25-7 irrespective of whether the acquiree elects to apply pushdown accounting.

ASC 805-50-25-9

The decision to apply pushdown accounting to a specific change-in-control event if elected by an acquiree is irrevocable.

6.8.3 Common control transactions

Consideration should be given to pushdown accounting in carve-out situations in which common control transactions occur. The guidance in ASC 805-50-30-5 states that if the net assets of a subsidiary that did not apply pushdown accounting are transferred to another entity under common control, then the parent company's basis of accounting should be used. In other words, the receiving entity in the common control transaction would reflect the net assets in its historical financial statements using the parent's basis. Accordingly, pushdown accounting would be applied.

Example common control transaction

A Parent entity owns Subsidiary A, which has applied pushdown accounting, and Subsidiary B, which has elected not to apply pushdown accounting. Prior to a divestiture transaction involving components of both Subsidiary A and Subsidiary B, Subsidiary B transfers the net assets intended for divestiture to Subsidiary A. Given that Subsidiary A and Subsidiary B are under common control, the guidance outlined in ASC 805-50-30-5 is applied to this transfer. Consequently, Subsidiary A recognizes the net assets of Subsidiary B using the Parent's basis of accounting rather than at Subsidiary B's historical carrying value. Therefore, when preparing the carve-out financial statements derived from Subsidiary A, which include the net assets from Subsidiary B, all assets in the carve-out financial statements are reflected at the Parent's basis.

ASC 805-50-30-5

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because pushdown accounting had not been applied, then the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.

6.9 Other disclosure considerations

Consistent with the limited guidance related to the creation of carve-out financial statements, there are no specifically required incremental disclosures for carve-out financial statements. The key principle to consider for carve-out financial statement disclosures is whether financial statement users are provided with sufficient information related to the methodology used to prepare the statements. Areas for consideration include, but are not limited to, the following:

- *The basis of presentation footnote* – This footnote is greatly expanded in a set of carve-out financial statements. It discloses, in a summary format, how the carve-out statements are derived. See Section 6.7, "Disclosure on carve-out judgments," for more details and a sample disclosure.
- *Related-party transactions* – As discussed in Section 3.18, "Intercompany balances and intercompany debt," the carve-out financial statements include transactions with related entities in the consolidated group, which requires incremental related-party disclosures. Additionally, cost allocations from the parent, in accordance with SAB Topic 1.B.1, are usually disclosed. For financial statements included in SEC filings, material related-party transactions are ordinarily required to be disclosed on the face of the financial statements pursuant to S-X Rule 4-08(k).
- *Income taxes* – The method of allocating the income tax provision and related accounts should be disclosed. Refer to Section 5, "Tax," for additional details.
- *Capital structure* – If the carve-out entity is a defined legal entity, it must present its equity accounts consistent with its legal capital structure, including share capital, additional paid-in capital (APIC), NIP, and AOCI. When carving out a component of a larger entity that does not comprise a

legal entity, the carve-out entity will not have a defined capital structure. In this case, until the consummation of an equity transaction, NPI represents the parent's interest in the recorded net assets of the carve-out entity and is shown in lieu of share capital and APIC (see Section 3.23, "Equity and NPI").

- *Purpose of the financial statements* – The purpose of the financial statements often determines many of the relevant disclosure requirements. For example, as detailed in Section 2.3.3, "Accounting requirements for S-X Rule 3-05 financial statements," segment information is not required for a Rule 3-05 filing if the acquired business is not a public entity, as defined in U.S. GAAP. However, segment disclosures may be required in other situations. The timing of the adoption of public company accounting standards and whether the carve-out financial statements need to comply with U.S. GAAP are other examples of how the purpose of the financial statements dictates the disclosure requirements.
- *Statement of cash flows* – Consideration should be given to presentation differences for the statement of cash flows. See Section 6.1, "Statement of cash flows," for further details.

7. Management considerations

Creating carve-out financial statements can be a complex process that requires careful planning and execution, as carve-outs can often come with tight deadlines driven by regulatory or commercial requirements. Management must ensure that the team responsible for this task possesses the necessary expertise, including strong technical accounting skills and familiarity with SEC reporting requirements (if applicable). Additionally, the team should be adequately staffed to handle any potential detailed data-gathering and analysis required to support potentially complex accounting, reporting, and disclosure requirements. Furthermore, the materiality thresholds for carve-out financial statements may differ from those of the parent entity, necessitating a thorough review of previously immaterial items. Robust internal controls tailored to the carve-out entity's specific needs are essential to ensure accurate and reliable financial reporting. The following sub-sections discuss these considerations in more detail.

7.1 Expertise

Ensuring the team responsible for creating carve-out financial statements has the necessary expertise is crucial because preparing the financial statements often requires the application of complex and judgmental aspects of U.S. GAAP. Given significant judgment may be required in creating carve-out financial statements, it is important that the team consists of members with strong technical accounting backgrounds and the ability to create robust audit support. Additionally, as discussed in the previous sections, there can be various additional financial reporting requirements if the carve-out financial statements are to be included within an SEC filing, so it is important for someone on the team to be proficient in SEC reporting requirements if applicable. Oftentimes, the use of other experts, including carve-out and SEC reporting subject matter specialists as well as tax or valuation specialists, may also be required.

7.2 Manpower

The preparation of carve-out financial statements may require greater manpower relative to other financial statements that management regularly prepares. Management must consider the appropriate number of staff needed to complete the carve-out financial statements on a timely basis. For example, if the carve-out entity is not its own legal entity but instead represents various parts of the parent, then it is possible that not all transaction-level information has been mapped to the carve-out entity in the accounting records. To carve out specific balance-sheet accounts, such as accounts receivable and accounts payable, the team may need to review individual invoices to determine their correct attribution. The data-gathering and analysis for various accounts may require a larger number of dedicated staff to complete the project in a timely manner compared to the carve-out entity's ongoing normal reporting needs. Additionally, the carve-out procedures need to be documented and supported in case the carve-out statements are audited, in which case, external auditors will evaluate this documentation and support to perform their audit procedures.

7.3 Time frame

When preparing carve-out financial statements, management must carefully consider the time frame required to complete the process. Carve-outs often come with stringent deadlines due to the events that necessitate their creation. Management should create a timeline to complete carve-out financial statements. For example, if S-X Rule 3-05 triggers the need for carve-out financial statements, then the acquirer of the carve-out has only four days from the triggering event to file Form 8-K, which is used to notify both the shareholders and the SEC of an important event, as well as an additional 71 days to file audited carve-out financial statements. This turnaround creates a hard deadline to complete the carve-out and to have an audit performed. Even if the timing of the carve-out financial statements is not governed by SEC reporting requirements, they often involve a transaction that may commercially impose abrupt closing deadlines. As such, management must establish a clear timeline to ensure timely completion and compliance with all necessary requirements. This proactive approach is essential to meet hard deadlines, such as those set by S-X Rule 3-05, and to navigate the complexities of the carve-out process effectively.

7.4 Materiality

When preparing carve-out financial statements, management must pay close attention to the materiality thresholds, which are often lower than those for the parent entity's consolidated financial statements. A lower materiality threshold can bring certain transactions into scope that were previously out of scope, requiring further accounting analysis and additional support for audits. The materiality threshold for carve-out financial statements may be lower than that of the parent entity, since carve-out financial statements are a subset of the parent's consolidated financial statements. Then again, items that were determined to be immaterial at the consolidated parent level may now be material at the carve-out entity level. Additional support and documentation may be required for an audit of the carve-out financial statements. Accordingly, management should evaluate materiality as part of the preparation process for preparing the carve-out financial statements.

7.5 Internal controls

When establishing internal controls for a carve-out entity, management must ensure these controls are tailored to the specific needs of the carve-out, which may differ from those of the parent entity. This is particularly important because the carve-out entity might operate under different materiality thresholds, necessitating adjustments or the implementation of new controls to ensure accurate financial reporting. Management must ensure that proper internal controls are in place for the carve-out entity. Since the carve-out entity may need to consider a different materiality threshold than the parent, the necessary internal controls around financial reporting may also differ for the carve-out, even if management has determined that they can rely on the internal controls of the parent entity. As such, management should evaluate internal controls when planning to prepare the carve-out financial statements.

Appendix

The following table contains the titles of guidance cited in this publication from the FASB Accounting Standards Codification (ASC), FASB Concepts Statements, the SEC Division of Corporation Finance's (CorpFin's) *Financial Reporting Manual*, SEC Regulation S-X, and SEC Staff Accounting Bulletins (SABs).

Quick reference	Title
ASC 205	*Presentation of Financial Statements*
ASC 220	*Income Statement – Reporting Comprehensive Income*
ASC 230	*Statement of Cash Flows*
ASC 235	*Notes to Financial Statements*
ASC 250	*Accounting Changes and Error Corrections*
ASC 280	*Segment Reporting*
ASC 330	*Inventory*
ASC 326	*Financial Instruments – Credit Losses*
ASC 350	*Intangibles – Goodwill and Other*
ASC 360	*Property, Plant, and Equipment*
ASC 405	*Liabilities*
ASC 460	*Guarantees*
ASC 606	*Revenue from Contracts with Customers*
ASC 715	*Compensation – Retirement Plans*
ASC 718	*Compensation – Stock Compensation*

Quick reference	Title
ASC 740	*Income Taxes*
ASC 805	*Business Combinations*
ASC 810	*Consolidation*
ASC 830	*Foreign Currency Matters*
ASC 842	*Leases*
ASC 855	*Subsequent Events*
ASC 932	*Extractive Activities – Oil and Gas*
FASB Concepts Statement 8	*Conceptual Framework for Financial Reporting*
SAB Topic 1.B.1	*Costs reflected in historical financial statements*
SAB Topic 5.Z.7	*Accounting for the spin-off of a subsidiary*
CorpFin's *Financial Reporting Manual*, 2005	*Definitions and Requirements*
CorpFin's *Financial Reporting Manual*, 2065	*Acquisitions of Selected Parts of an Entity*
SEC Regulation S-X, Rule 1-02	*Definitions of terms used in Regulation S-X (17 CFR part 210)*
SEC Regulation S-X, Rule 3-01	*Consolidated balance sheets*
SEC Regulation S-X, Rule 3-05	*Financial statements of businesses acquired or to be acquired*
SEC Regulation S-X, Rule 3-12	*Age of financial statements at effective date of registration statement or at mailing date of proxy statement.*
SEC Regulation S-X, Rule 3-13	*Filing of other financial statements in certain cases*
SEC Regulation S-X, Rule 4-08	*General notes to financial statements*

Quick reference	Title
SEC Regulation S-X, Rule 5-02	*Balance sheets*
SEC Regulation S-X, Rule 8-08	*Age of financial statements*
SEC Regulation S-X, Article 11	*Pro Forma Financial Information*

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