

IFRS News

Shedding light on the IASB's activities*

Carve-out/combined financial statements – supplement • March 2008

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Carve-out/combined financial statements

IFRSs provide very limited guidance on the preparation of carve-out/combined financial statements. In this supplement Global ACS partner Olivier Scherer shares the responses from PwC's Global Capital Markets specialists on their local market experience, and answers some commonly asked questions. The answers to the questions may be different in different countries. This supplement illustrates some of the more frequent questions and the answers from specific countries or regulators. Consultation with the relevant experts and lawyers is crucial.

What are 'carve-out' and 'combined' financial statements?

The terms 'carve-out' and 'combined' financial statements have a similar meaning. Combined financial statements are the aggregate of the financial statements of segments, separate entities or groups, which fail to meet the definition of a 'group' under IAS 27 *Consolidated and Separate Financial Statements*. Carve-out financial statements are the separate financial statements of a division or lesser business component(s) of a consolidated or larger entity. The term used varies by country and regulator. For example, the UK commonly refers to 'combined' financial statements and the US refers to 'carve-out' financial statements.

When can carve-out/combined financial statements be prepared?

Preparation of carve-out/combined financial statements is seldom straightforward. Common issues include:

- whether carve-out/combined financial statements can be presented;
- determining what the reporting entity is;
- how to measure assets and liabilities; and
- how to allocate different types of costs, income, taxes etc.

Participants agreed that carve-out/combined financial information should be prepared only when all of the entities concerned have been under common control during the track record period and form a 'reporting entity'.

"Carve-out/combined financial statements are usually prepared in contemplation of a capital market transaction and might be required by the local regulator."

David Smailes

What are the regulatory requirements and market practice regarding the preparation of carve-out/combined financial statements?

Most territories have no specific regulatory requirements for the preparation of combined financial statements. The most detailed and structured guidance available is that issued by the SEC with respect to US GAAP, and the UK Annexure to the Standard for Investment Reporting (SIR) 2000 for the presentation of financial information in an investment circular. Many territories find this guidance useful. However, since most carve-out or combined financial information is prepared with a view to a capital market transaction, experts recommend entities clear potential issues with the local regulator in advance, as different regulators may take different views.

"The general principles governing preparation of carve-out financial statements have been developed over the last two decades and captured through SEC speeches, comment letters and past examples of carve-out financial statements."

Neil Dhar

Conscious about the need to define a framework which provides guidance to EU preparers, the European Commission is currently working on a project to issue the equivalent of SIRs. The first part of the project looks at pro formas.

“Under French GAAP, aggregating financial statements of separate legal structures is allowed in certain circumstances. This practice has evolved while transitioning to IFRS to a model which looks beyond the legal structures and considers the business of the reporting entity.”

Thierry Charron

What is the difference between carve-out/combined financial statements and pro forma financial statements?

Making the distinction is important because an audit opinion cannot be issued for pro forma financial statements.

The same principle is applied consistently in all respondents’ territories:

- carve-out/combined financial statements present **historical** financial information prepared by aggregating the financial information of entities under common management and control, which did not form a legal group.
- Pro forma financial statements present **hypothetical** financial information created to present an illustration of how a capital market transaction might have affected an “issuer” of securities, had a specific transaction or series of transactions been undertaken at the commencement of the period being presented, or at the balance sheet date presented.

The meaning and interpretation of the term ‘pro forma’ might differ from territory to territory, and there might be some differences in the preparation of pro forma financial statements.

“In some territories carve-out/combined financial statements have been referred to as ‘pro forma’ and presented as audited historical financial information. This use of the same term for dissimilar financial information should not be confused with the concept of illustrative pro forma financial information on which a compilation opinion rather than an audit opinion is given, as contemplated by the European Prospectus Regulation and associated guidance.”

David Smailes

“Germany has issued a standard governing the preparation of pro forma financial information (as has the SEC in its Regulation S-X). In all cases, there should be some basis or framework to support the compilation of pro forma financial information.”

Nadja Picard

What is a ‘reporting entity’, and what are the general indicators that a reporting entity exists for which IFRS financial statements can be prepared?

The IFRS Framework defines reporting entity as “an entity for which there are users who rely on the financial statements as their major source of financial information about the entity”.

Capital market specialists look at all the facts to assess whether a reporting entity exists. These include:

- Whether the assets and liabilities included in the carve-out are legally bound together through:
 - a legal reorganisation of a group/groups that has occurred after the reporting date, but prior to the publication of the financial statements;
 - a reorganisation that will happen simultaneously with a proposed IPO, disposal or similar transaction; or
 - an agreement that was signed and in place throughout the historical financial period. The written agreement cannot be put in place retrospectively; or
- Whether the assets and liabilities are all owned by the same party, and whether there is evidence that they have been managed together as a single economic entity during the track record period? All the owner’s assets and liabilities managed in this way should be included.

“A material level of transactions between the businesses or with common customers/suppliers would make it more difficult to present meaningful carve-out/combined financial statements for one of the businesses.”

David Smailes

‘Managed together’ is not usually interpreted as meaning that a group with two business segments can not present carve-out/combined financial statements for one of the two segments. However, presentation of carve-out/combined financial statements would require further analysis of the relationships between the two segments to determine whether the business segments are related or interdependent, or if there are any material inter-business relationships.

Example

An acquisition company, Newco, has been created. The directors of Newco prepare an IPO prospectus which includes a commitment to use the proceeds of the IPO to acquire a segment of an existing third party company, Opubs. Opubs did not previously report separate financial information and is a mix of legal entities and divisions.

The issuer is Newco. The prospectus must include an audited

track record for the business of Newco but this is not represented by Newco’s legal financial information. Typically the prospectus would therefore include:

- Carve-out/combined historical financial information on Opubs; and
- Pro forma information for the enlarged Newco group, illustrating how Newco’s financial information would have looked if Newco had already acquired Opubs.

Example

When one entity, which is managed together with others as part of the same business segment, will not be subject to the legal reorganisation, should the entity be included in the reporting entity?

It is important not to present misleading information: A high level of transactions between the business excluded and the carve-out group could lead to misleading carve-out financial statements. For example if the excluded business was a loss making entity as a result of transactions with the carve-out group which were not performed at arm's length.

This is a complex issue when regulatory approval is sought. It requires judgement and should be addressed upfront when planning for carve-out/combined financial statements.

Neil Dhar

What are the allocation principles for assets, liabilities, income and expenses?

The most common areas where allocations have to be made are headquarters costs, income taxes, debt and interests. Each situation is unique and requires consideration based on the facts available.

"Factors usually considered when doing the allocation include:

- Will the assets and liabilities be transferred to the carved-out group?*
- Was there any intra group recharge between the parent and the carved-out group, eg legal, accounting, finance expenses? and*
- Have the recharges been made on an arm's length basis?"*

Gabriele Matrone

Allocations can only be made to the extent of the costs actually incurred by the larger group. That is, no allocation can be made on a "what if" basis. For example, allocation would not be made on the basis of estimating what the expenses of the carved-out business would have been if it had had its own legal department. Such an approach would be more akin to pro forma financial information.

Quality of the information is a pre-requisite for the allocations. These must be performed to a standard that allows presentation within IFRS financial statements and, in most cases must be auditable. If quality information does not exist, a preparer should provide sufficient disclosure in the notes to enable readers of the carve-out/combined financial statements to understand how the future financial position, performance and cash flows of a stand alone business may differ.

Whichever method is used to allocate assets, liabilities, income and expenses, clear and meaningful explanations in the notes are essential for a good understanding of the financial statements. The UK and SEC material referred to above provides useful guidance in respect of allocation.

Kennedy Liu shares some recent comments from the Hong Kong Stock Exchange

"Please disclose the basis of allocation in the basis of preparation"

"Has management disclosed its judgement that the carve-out is appropriate in the critical accounting policies?"

"Has management disclosed details of the carve-out business in the basis of preparation?"

"Advise and disclose the basis on how "common control" is established."

"Is it appropriate to use the carve-out approach or the discontinued operation approach in preparing the financial statements?"

"Does the carve-out satisfy the criteria under UK Standard for Investment Reporting 2000?"

"Do the carve-out financial statements comply with HKFRS/IFRS?"

How are income taxes dealt with?

Respondents identified the following examples:

Tax position	Treatment of tax
The entities that comprise the carved-out business filed separate tax returns	Tax expenses, assets and liabilities are accounted for in accordance with the tax returns.
The entities that comprise the carved-out business were part of a consolidated tax group.	<p>a) Separate tax return approach: under this method, income tax is recalculated and accounted for as if the entity had always filed tax returns separately. Particular attention should be paid to tax losses when the tax asset has already been used by another entity in the group that is not part of the carved-out business.</p> <p>Or</p> <p>b) Actual tax incurred: this method would be possible if the parent recharged taxes to the entities that comprise the carve-out/combined business.</p>

How should debt and interest expense be allocated?

Respondents agreed that intercompany debt between the carved-out business and the parent should be reinstated in the carve-out/combined financial statements, along with the associated interest expense incurred.

Example

Financing of 100 was provided in the past. 150 of group debt will be allocated in the restructuring:

100 should be allocated to the carved-out business *(continued)*

(continued) as it reflects the amount attributable to the carved-out business. However, in certain circumstances, it might also be acceptable to allocate 150, rolled back to the balance sheet of the earliest year presented along with the related interest expense, as long as the additional 50 does not represent a pro forma type adjustment.

An analysis of the final capital structure (pre transaction) should also be performed.

“A practical difficulty, arising when interest free loans were granted by the parent to the entities that comprise the carved-out business, is that the allocation of the actual interest expense requires an analysis of the capital and debt structure of the wider group. For example, if the interest free loans were backed by interest-bearing loans that are external to the group, the interest paid on these loans could be used.”

Gabriele Matrone

How much assurance can auditors give on carve-out/combined financial statements?

There is accepted practice of giving some kind of assurance on carve-out/combined financial statements when the financial statements are those of a reporting entity and can be satisfactorily audited.

An audit opinion might refer to “true and fair” or “fair presentation in accordance with IFRS”. However, in certain circumstances, it might be more appropriate to refer to the basis of preparation. The greater the number of adjustments and allocations that have to be made to achieve a carve-out/combined presentation, the less likely it is that an IFRS opinion can be issued.

“Referring to the basis of preparation is widely accepted in the UK for an opinion given on historical financial information presented in an investment circular under SIR 2000.”

David Smailes

An ‘emphasis of matter’ paragraph is also commonly used in the auditors’ opinion. This explains that the carved-out business has not operated as a separate entity, and that the financial statements are not necessarily indicative of results that would have occurred if the business had been a separate stand-alone entity during the period presented, nor is it indicative of future results of the business.

“It is common practice in Hong Kong to issue an unqualified audit opinion without an ‘emphasis of matter’ paragraph. Even so, it would usually be appropriate to include such disclosures in the notes to the carve-out/combined financial statements.”

Kenny Liu

What are the practical challenges faced in the preparation of carve-out/combined financial statements?

The practical challenges vary depending on circumstances. Respondents highlighted three key areas:

1. The structure of the carved-out business:
Financial statements are easier to prepare when they are an aggregation of separate legal entities each of which has their own stand-alone financial statements. Preparation of financial statements is more complex when it entails carving out portions of legal entities.
2. The interactions between the carve-out/combined business and the rest of the group:
The extent of those interactions determines the complexity of identifying and reinstating inter-company transactions and allocating income, expenses, assets and liabilities.
3. The quality of the accounting records, internal controls, processes and systems:
The financial statements must be prepared reliably and must be auditable.

“One practical difficulty we face is segregating working capital balances, such as accounts receivable, accounts payable and inventory.”

Neil Dhar

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