Carve-Out Accounting

Complex Accounting and Risk Management

Large companies often strategically divest or sell off parts of a business for several reasons, including but not limited to improving shareholder value, raising cash, or focusing on their core business. These transactions usually require stand-alone or carve-out financial statements of the subsidiary, division, or product line that are subject to the divestiture, spin-off, or Initial Public Offering (IPO).

There is no legal or accounting definition for carve-out financial statements. However, the aim of carve-out accounting is to fairly present the historical operations of the carve-out entity and provide insights into its performance under the parent company. This requires a reasonable methodology to ensure the allocation of assets, liabilities, revenue, and expenses from the parent company's consolidated financial statements to the carve-out entity are deemed reasonable and appropriate.

When determining whether carve-out financial statements are required, it is crucial for a company to assess the specific details of the planned transaction. This includes considering the information requirements of stakeholders and adhering to any relevant SEC reporting regulations. Carve-out financial statements may be mandated to meet SEC reporting requirements, especially in scenarios involving significant business acquisitions, spin-offs or split-offs of all or part of a business to existing shareholders, or an IPO.

In instances where a registrant is obligated to include carve-out financial statements in an SEC filing, the applicable SEC rules will govern both the structure and content of the filing. This includes determining the historical periods for presentation and specifying whether the financial statements need to be audited.

Successfully executing a carve-out transaction requires thorough preparation and assessment, as the complexity of the process is often underestimated. Failing to adequately plan for the carve-out transaction can introduce risks and uncertainties, which could result in a lower valuation, an extended timeline, or even a sale failing to be completed.

One of the main challenges companies need to be prepared for is assessing the economic activity of the carve-out entity to determine which assets, liabilities, revenue and expenses to be included. This requires significant judgment and impacts various balance sheet and income statement accounts. Past analysis may not have included this level of detail, and often materiality will be different from anything audited at the parent company level. The complexity will be impacted by the quality and structure of the existing financial accounting and reporting of the area to be carved out. Common areas that may require significant judgment and estimates include the allocation of the spin-off entity's share of the following:

- General and administrative costs, such as corporate overhead, insurance, IT services
- Intercompany transactions including loans, leases, shared services
- Intangible assets such as goodwill
- Tax liabilities and benefits

US GAAP does not require the parent and the carved-out entity to follow the same accounting principles. Therefore, management should be prepared to provide documentation on significant judgments and estimates made when preparing the carve-out financial statements. Technical memos may be required on an account-by-account basis to provide sufficient support for audits or due diligence activities. In addition to complex accounting judgments, management will often be under pressure due to limited internal resources and will need to engage outside experts on a variety of topics including legal structure, tax implications, and valuations. Identifying key areas to tackle internally, and which areas to outsource is critical to meeting deadlines.

Compounding these challenges is that US GAAP does not provide specific guidance on the preparation of carve-out financial statements. Lack of specific guidance has led to certain SEC staff guidance. While this guidance is only applicable to public entities, it has become widely accepted for private companies as well. Commonly used SEC guidance includes:

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

THE CHESS CONSULTING ADVANTAGE

Our experienced team leverages its financial reporting, accounting, auditing, and government contract cost accounting and regulatory compliance expertise to assist companies with mitigating the complexities and risks associated with a divestiture. We provide comprehensive support throughout the entire spin-off process, including project planning, risk assessments, technical accounting assistance, cost accounting/allocation analysis, financial statement preparation, and post-transaction support.

Notable experience includes:

A spin-off for a large government and commercial IT services company. To complete the acquisition of a large IT services company by a private equity firm, the spin-off and sale of the company's commercial business segment was required. Chess was engaged to support the transaction, including the carve-out accounting and reporting. We also provided technical accounting guidance and support related to purchase accounting and complex equity plans related to the sale.

Audit readiness for a government contractor. Assisted a government contractor with the completion of its external audit after the auditors pulled out of the field due to the condition of the company's general ledger and related account support. Our work involved the cleanup of the books and records, development of account analyses, correction of contract revenue recognition and development of technical accounting white papers needed to support accounting positions. The company was able to obtain an unqualified/clean audit opinion prior to its covenant deadline and subsequently maintained enhanced accounting and reporting practices due to the improvements made to the monthly closing processes and procedures implemented as part of our engagement.

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When the right move matters, contact Chess Consulting.