IFRS news

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Solving the mystery of carve-out financial statements

Rich Jones, divestment specialist, explains what carve-out financial statements are and what they may be used for.

There has been a steady stream of high profile divestments over the past 10 years. Companies have demerged, spun-off or sold non-core assets in response to changing market conditions.

Divestments often result in a requirement to prepare and have audited special purpose carve-out financial statements. But what are carve-out financial statements? What are they used for? How do they differ from other numbers that you may have prepared for diligence? Why can they be so tricky?

What are carve-out financial statements?

Carveout financial statements are the financial statements of a division or business component of a larger entity; for example, a group of similar products and operations, or a segment of a listed business.

Carve-out financial statements typically reflect financial information for economic activities that are bound together by common control, but are not a legal group. These are usually prepared by aggregating the financial information of segments, separate entities or components of groups that fail to meet the definition of a 'group' under IFRS 10. Such carve-out financial statements are often referred to as combined financial statements.

What are they used for?

Audited historical financial statements are required in divestitures more than ever for a variety of reasons, usually based on the needs of the buyer:

Buyer comfort:

Audited financial statements provides a solid base to diligence a business, and buyers often require a completed audit as a condition to close. However, this is not always the case, and a detailed and well-prepared data room can often provide the buyer with significant comfort and may abate a buyer's desire for audited financial statements.

Public company reporting:

Carve-out financial statements are often required for part or parts of a group in connection with a transaction of some nature – disposals, distributions, business combinations, spin-offs and initial public offerings (IPOs). For example, both the UK Listing Rules and SEC regulations may require buyers to file audited financial statements. The preparation of audited carve-out financial statements is required when those acquired businesses are not groups of legal entities.

Financing:

Buyers that require financing may require audited financial statements, even if they are non-public companies. For example, a private equity house looking to raise capital to fund the acquisition of a carved out business through a high yield bond. They will often require audited carve-out financial statements for inclusion in an offering memorandum to be made available to potential investors.

How do they differ from numbers prepared for diligence?

A set of audited financial statements will need to fully comply with GAAP, whether that be IFRS, US GAAP, or local GAAP. For IFRS, this means a full income statement, a complete balance sheet, cash flow statement and a full set of note disclosures. Pension disclosures, share based payment disclosure and reconciliations of movements in equity are all included. And all of this for up to three years!

Audited financial statements differ to the information included in an information memorandum or diligence report ('deal financials'), which may be restricted to primary statements, and may omit key items required by GAAP, such as depreciation, amortisation, and non-recurring costs.

It is important to reconcile deal financials provided to prospective buyers back to audited carve-out financial statements, and explain why those differences exist, as it is important to explain why they do not impact deal value.

And the tricky bit?

The preparation of carve-out financial statements can require considerable judgement. Each transaction is different and each set of combined financial statements will present unique challenges. The nature of the transaction, the boundary of the reporting entity, the quality of the accounting records, the past practices and policies of the parent, and the views of the relevant regulator are very important.

Companies will often have fairly granular income statement data but the same cannot be said for balance sheet data. A common difficulty is the identification of working capital balances, particularly accounts receivable. Such supporting ledgers are typically not maintained on a product by product basis. The data will need to be extracted either manually, or by using modern data techniques.

Other complex areas associated with carve -out financial statements often include the treatment of corporate allocations, debt, intercompany balances, pensions, share based payments, and taxes.

Other considerations

Carve-out financial statements are one piece of the divestment puzzle. The primary objective of disposing a business is typically to maximise value for shareholders.

Sellers will need to create a compelling exit story for buyers that conveys that the deal is good value for both existing shareholders and for prospective buyers, whether that be private equity, corporate buyers, or equity investors in a spin (IPOs).

Sellers will need to consider diligence requirements, separation costs, the on-going operation model, tax impacts, accounting implications, people matters— the list goes on.

The key to a successful divestment is to start planning early.

The Leases Lab

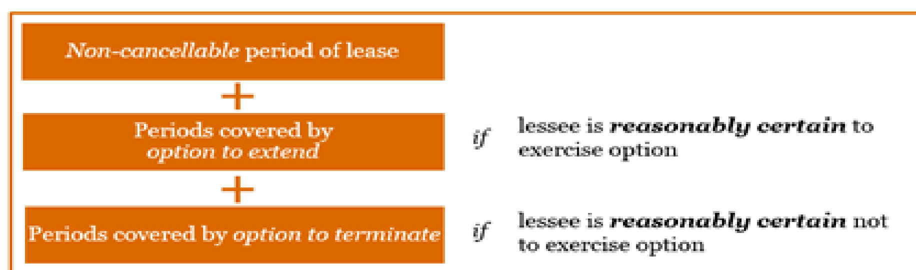
The lease term is key when calculating the lease liability. Professor Lee Singh and his assistant Holger Meurer explore how to determine the lease term. Let's experiment!

Hypothesis

Determining the lease term is easy – the period starts when the contract is signed and ends at the contractual maturity date.

Testing and analysis

The lease term contains two components. First, the non-cancellable period for which a lessee has the right to use an underlying asset. Second, periods covered by an extension option or a termination option of the lessee. These periods are included only if the lessee is reasonably certain to **exercise** the extension option or **not to exercise** the termination option.



The lease term starts at the commencement date. This is the date on which a lessor makes the underlying asset available for use by a lessee. The commencement date may differ from the date at which the contract is signed.

Reasonably certain?

Assessing whether or not a lessee is reasonably certain to exercise an option is challenging. All facts and circumstances creating an economic incentive for the lessee to exercise the option must be considered.

Examples of such factors are:

- Contractual terms for optional periods compared with market rates;
- Significant leasehold improvements undertaken;
- Costs relating to the termination of the lease or signing of a replacement lease;
- The importance of the underlying asset to the lessee's operations.

An entity assesses whether or not a lessee is reasonably certain to exercise an option at the commencement date. It adjusts this assessment in later periods only if certain criteria are met.

Practical application

The length of the lease term is one of the key inputs that determines the amount of the lease liability and the right-of-use asset. The determination of the lease term can be complex and requires judgement, in particular when the lessee has an extension or a termination option.

Conclusion

The hypothesis is wrong.

The lease term does not start when the contract is signed but at the commencement date of the lease. Furthermore, periods covered by a lessee's extension or termination option are included depending on whether the lessee is reasonably certain to exercise the option. The end of the lease term can therefore differ from the contractual maturity date.

For more on the determination of the lease term, see our In depth, IFRS 16 – A new era of lease accounting.
You might also find our video series helpful.

Proposed tweak to IFRS 8, Operating Segments

Joanna Demetriou provides the latest from the standard setter - the IFRS 8 Exposure Draft.

The IASB issued the Exposure Draft (ED) of the Amendments to IFRS 8 Operating segments. The response to the post implementation review of IFRS 8 was broadly positive, therefore the changes proposed are small.

The amendments focus mainly on five areas:

Definition of the CODM:

The amendment aims to better describe the CODM as a function rather than an individual that makes both operating decisions as well as decisions over the allocation of resources.

The amendment clarifies that the CODM can include non-executive directors.

Segment reporting differs from reporting presented in an annual reporting package:

The Board has 'defined' an annual reporting package as a publicly available set of documents published at the same time as the annual financial statements that communicate the annual results to the users. The amendment requires preparers to provide a reconciliation if an entity's reportable segments in the annual reporting package are different to those reported in the financial statements.

Material reconciling items between segment reporting and IFRS:

More information on the reconciling items will be required to ensure that users can understand what the reconciling items are.

Presentation of additional information:

Responders to the PIR indicated that managements often review more than one set of information. The ED allows presentation of additional information if this information will allow users to better understand the operating decisions and decisions made by the CODM.

Interim reporting impact:

Finally, the Board requires amendment of comparatives in interim reports, when segment reporting is amended.

What does this mean?

The amendments are not expected to cause a significant change in segment reporting. The amendments are broadly consistent with what is applied in practice in relation to the determination of the CODM. Additional disclosures proposed may shed some light in areas where segment reporting did not agree with other publicly available information or IFRS. The comment letter period ends on 31 July 2017.

LIVE WEBCAST

IFRS 15 Revenue: Practical experiences from the market

Wednesday 24 May 2017
3:00pm (UK)

Our experts will provide an overview of some of the key challenges we are observing at companies that are in the throes of implementing the new guidance. We will also share our perspectives on the practical steps you should be taking now to be ready in time for the new rules.

Register at **www.pwc.co.uk/ifrs15**

Nitassha Somai, Financial instruments expert, works through one of the biggest impacts of IFRS 9 on corporates— Intragroup loans

Scene 2, Take 1: Demystifying IFRS 9 for Corporates: Intra-Group loans

LIGHTS, CAMERA, ACTION!

Dear Corporate,

You may have dismissed the impact of IFRS 9 on intra-group funding ('funding') because it is eliminated on consolidation. However, the impact in separate financial statements could be significant.

This article explores the impact of IFRS 9 on intra-group funding, particularly when a parent advances funding to its subsidiary.

1. Not all intra-group funding is scoped into IFRS 9

Scope is not expected to change. Funding in the scope of IAS 39, '*Financial instruments: Recognition and measurement*' (IAS 39) will also be scoped into IFRS 9.

Intra-group funding with written terms would generally fall into the scope of IFRS 9. All requirements of IFRS 9 will therefore apply, including impairment.

> Intra-group funding with no written terms is more judgemental. There maybe no fixed repayment date and no interest is charged.
>
> These loans may be scoped out of IFRS 9 if the economic substance of the transaction is that of a long term capital injection rather than a receivable. Past practice and payment history should be considered in assessing the substance.
>
> Capital injections are out of scope of IFRS 9 and fall within scope of IAS 27, '*Separate Financial statements*'. Different measurement and impairment rules apply.

2. The full impairment model applies

Intra-group loans do not qualify for the simplifications in IFRS 9. The full impairment model needs to be applied therefore a 12 month expected credit loss will be recorded on the day funding is advanced.

Subsequently, if there is a significant increase in credit risk, for example if the subsidiary's trading performance declines, the impairment loss will be increased to a lifetime expected credit loss.

Bigger and more volatile provisions are expected.

> **The top 3 judgmental areas are:**
>
> - Indicators for a significant increase in credit risk must be developed.
> - Forward looking information as well as past events must be incorporated.
> - The contractual period over which to assess impairment may not be clear.

3. Cash advanced might not be fair value

Intra-group loans in the scope of IFRS 9 are required to be measured at fair value on initial recognition. Intragroup loans are often either interest free or are provided at below-market interest rate. The amount lent is therefore not fair value.

> **Top considerations are:**
>
> - **Off market/nil interest rate is not fair value** –Practically this means the cash advanced will not be the receivable recorded. Instead the receivable will be recorded at a lower amount to take into account the impact of discounting at a market interest rate.
> - **Day 1 difference** – A day 1 difference arises between the cash advanced and the recorded receivable. This difference is added to cost of investment in subsidiary because it is the nature of relationship that gives rise to the off market/interest free loan.

01 *Not all intra-group funding is in scope of IFRS 9*

02 *The full impairment model applies*

03 *Cash advance might not be fair value*

Conclusion

- IFRS 9 will affect intra-group funding in separate financial statements.
- Funding with no written terms, repayment date and interest payments might not be in scope of IFRS 9.
- The general impairment model must be applied to loans in scope. This gives rise to a day 1 impairment loss and bigger more volatile provisions.
- Off market/interest free loans are not fair value and give rise to a day 1 difference.

CUT!!!

Our full range of IFRS 9 content and videos can be found here

IFRIC Rejections Supplement- IAS 34

Looking for an answer? Maybe it was already addressed by the experts

The Interpretations Committee (IC) regularly considers anywhere up to 20 issues at its periodic meetings. A very small percentage of the issues discussed result in an interpretation. Many issues are rejected; some go on to become an improvement or a narrow scope amendment. The issues that are not taken on to the agenda end up as 'IFRIC rejections', known in the accounting trade as 'not an IFRIC' or NIFRICs. The NIFRICs are codified (since 2002) and included in the 'green book' of standards published by the IASB although they technically have no standing in the authoritative literature. This series covers what you need to know about issues that have been 'rejected' by the IC. We go standard by standard and continue with IAS 34 as per below.

IAS 34 has not been a frequent topic for the Interpretations Committee with only two agenda decisions in recent years.

Fair Value

The Committee was asked in 2009 whether condensed financial statements should include fair value disclosures. It concluded that the guidance in IAS 34 was clear. Interim financial information updates the previous annual statements and should therefore provide sufficient information for users to understand changes to the financial performance and position of an entity. Fair value disclosures that would be significant to a user's understanding should be included.

IFRS 13 amended IAS 34 so it is now explicit that certain disclosures specified in IFRS 13 and IFRS 7 must be included in interim financial statements.

Cash flow statements

In 2014, the Committee was asked about the cash flow statement in condensed interim financial statements. IAS 34 requires that an entity must include "..at a minimum, each of the headings and subtotals that were included in its most recent annual financial statements…". The submitter suggested that this minimum could be satisfied by three lines, operating, financing and investing in a condensed statement.

The Committee did not expect a three line presentation alone to meet the requirements in IAS 34, although they didn't explicitly rule it out. IAS 34 requires disclosure sufficient to enable users to understand developments in the interim period. The statement of cash flows specifically should include all information that is relevant in understanding the entity's ability to generate cash flows and the entity's need to utilise those cash flows. The committee rejected the issue as the standard was clear.

The IFRS 15 Mole

PwC revenue specialists and the IFRS 15 Mole investigate how to identify a principal or an agent in a revenue transaction

Suspects

Accounting for variable consideration.

Incident description

It can be difficult to determine revenue when the amount of consideration due from a customer is dependent on the outcome of a future event. Examples include:

- contracts with early completion bonuses in the construction industry or;
- volume related discounts or rebates.

Step 3 of the 5-step revenue model requires entities to estimate variable consideration and allocate it to the performance obligations at contract inception. However, variable consideration is included only when it is highly probable there will not be a significant reversal of revenue when the uncertainty is resolved.

This is a new and potentially challenging area of judgment . Even if it is not highly probable that all the variable consideration will be received entities must consider whether there is a minimum amount (variable or not) that does pass the threshold and should be recognised. This may be a change to current practice for many. There is a need to revise estimates of variable consideration at each reporting date and throughout the contract period. Any changes in contract price would be allocated to the relevant performance obligations in the contract.

How should revenue be estimated?

The revenue standard provides two methods:

1. **Expected value** is based on a weighted average of the range of possible outcomes; or
2. **Most likely amount** is the single, most likely amount of consideration in a range of possible amounts.

The method used should be that which management expects will best predict the amount of consideration that is going to be received. It is not a policy choice.

Recommendations

Variable consideration is assessed at the contract level and needs additional analysis throughout the contract period. Management needs to consider whether the highly probable threshold is met, and whether that assessment changes. Factors to consider include:

- the amount of consideration highly susceptible to factors outside the entity's influence;
- whether uncertainty is to be resolved and over what period;
- entity's experience of similar types of contract, and
- whether the contract has a broad range of possible consideration amounts.

Beware of situations where the potential reversal of cumulative revenue recognised is not significant. The threshold will be met in this case.

Further investigations

Be aware of factors that impact revenue subject to external influences.

Facts—How to calculate variable consideration

Volume discounts

An entity enters into a one-year contract to deliver paint. The contract stipulates that the price per pot will be adjusted retroactively once the customer reaches certain sales volume, as follows:

C100 – 1 to 1,000,000 pots

C90 – 1,000,001 to 3,000,000 pots

C80 – more than 3,000,000 pots

Based on the entity's experience, it estimates that the total sales volume for the year will be 2,800,000 pots and that it is highly probable that the volume will not be less than 1,000,001 pots.

The entity sells 700,000 pots to the customer during the first quarter and receives the contract price of C100 per pot of paint.

Revenue is recognised using a selling price of C90 per pot as the entity concludes that it meets the highly probable threshold. The additional C10 per pot is recognised as a contract liability.

Performance bonus with multiple outcomes

A contractor enters into a contract to build an asset for C100,000, with a potential performance bonus of C50,000 based on the timing of completion. The performance bonus decreases by 10% for every week of delay.

The contractor estimates that there is a 60% probability that the contract will be completed by the agreed-upon completion date, a 30% probability it will be one week late, and a 10% probability it will be two weeks late.

The total transaction price is the probability-weighted estimate, which is C147,550 (100,000+(0.6* 50,000) + (0.3 * 45,000) + (0.1 * 40,500)).

Performance bonus with two outcomes

As with the last case, there is a performance bonus. This time a C25,000 bonus will be received if the asset is completed by a specified date. The contract is expected to take three years to complete.

The contractor believes, based on its past experience, that it is 95% likely that the contract will be completed successfully on the target date.

The transaction price is the most likely amount and the contract's transaction price is therefore C125,000.

Cannon Street Press

Editors choice

Definition of a Business exposure draft (ED)

The Board discussed comments on the 'screening test' introduced in the ED. The ED proposes that a transaction is an asset acquisition if substantially all of the fair value is in one asset or a group of similar assets. The Board had received mixed feedback on the screen and whether it should be a rule or an indicator. The Board tentatively decided to make the screen optional on a transaction by transaction basis. The FASB have included the screen test in their revised standard and therefore this would be a GAAP difference .

Other Highlights

IFRS Maintenance

Fees included in the '10 per cent' test

The Board tentatively decided to propose an amendment to IFRS 9 to clarify the '10 per cent' test to assess whether to derecognise a financial liability. The amendment would confirm the test should include only fees paid or received between the entity and the lender, including fees paid by either party or received on behalf of the other party.

Amendments to IAS 19 and IFRIC 14

The Board tentatively decided that an entity should apply the amendments to IFRIC 14 retrospectively and the amendments to IAS 19 prospectively, with no transition relief for first-time adopters. The effective date has not yet been set.

Amendments to IFRS 3 and IFRS 11 – previously held interests in joint operations.

The Board discussed the proposed amendments to IFRS 3 and IFRS 11 for previously held interests in a joint operation.

- The IFRS 3 amendment clarifies that when an entity obtains **control** of a business that is a joint operation it should remeasure the previously held interest.
- The IFRS 11 amendment clarifies that when an entity obtains **joint control** of a business that is a joint operation, the entity does not remeasure previously held interests.

The Board tentatively decided to finalise the amendment.

These are the editor's top picks from the April Board meeting. For a comprehensive list of all discussions visit the IASB website www.IFRS.org

The bit at the back ...

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