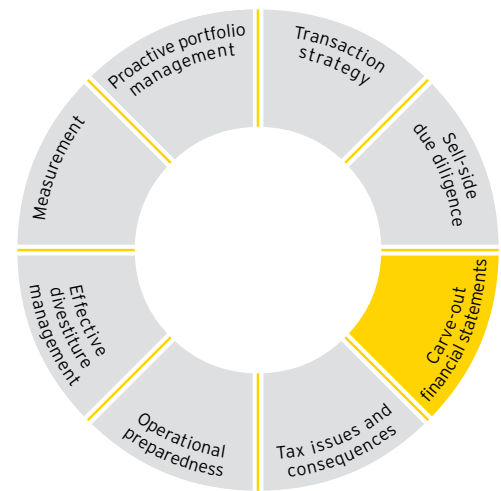


Carve-out financial statements

Carve-out financial statements help present a clear and credible picture of the future stand-alone business. Well-thought-out financial statements help crystallize the buyer's understanding, build the value case for the business and accelerate a closing.



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Key points:

- ▶ Allocate adequate expertise to preparing carve-out financial statements
 - ▶ Consider potential buyer and seller requirements in determining the appropriate form of carve-out financial statements
 - ▶ Invest the time upfront to prepare compliant, accurate, thorough carve-out financials
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by Paul Hammes and Bill Kierse

To carry out successful divestments, sellers must determine the value of the business or assets being sold and clearly communicate that value via financial statements. In the case of a carve-out, in which a subsidiary, division or other asset set is separated from a larger company, creating a carve-out or stand-alone financial statement is a complex exercise. This is particularly true when the historical "business" as it was managed and reported does not correlate exactly to the business being sold.

Although carve-out financial statements are crucial to value preservation and, in many cases, will have to be audited due to SEC, lender or other requirements, corporate sellers often fail to prepare these statements adequately. The process is time-consuming. Under liquidity and other pressures, sellers may be in a hurry to complete the deal so buyers don't lose interest or financing.

Haste, though, can be counterproductive if it means cutting corners. It's important to understand the likely buyers of the business and their potential needs regarding financial statements as well as the seller's own requirements regarding historical financial data. Not taking the time up front to do this often means delayed closings, reductions in purchase price and issues with lenders. Indeed, audited carve-out financial statements are often required today to get a deal closed.

Different forms of statements

In a public transaction, especially in the US, financial statements generally must comply with SEC guidance. Some private transactions, such as a sale to a PE fund or private company that may issue public debt or equity, also require public filings. However, while there are guidelines related to specific aspects of carve-out financial statements, much is based on historical practice.

Executives, in consultation with their internal compliance leaders, auditors and transaction advisors, must exercise significant judgment.

To determine what information to include in the financial statements, firms must consider investor needs, availability of information, the nature of the business and whether or not the transaction will be subject to public filing requirements. Carve-out financial statements may take any of the following forms:

- ▶ Unaudited
- ▶ Audited but not compliant with the rules and regulations of the US Securities and Exchange Commission (SEC)
- ▶ "Special purpose" financial statements, based on defined business activity, audited but not to be used in SEC filings
- ▶ Audited and prepared in accordance with SEC rules and regulations
- ▶ Audited in accordance with standards published by the Public Company Accounting Oversight Board (PCAOB) and prepared in accordance with SEC rules and regulations

While issuing unaudited financial statements may seem the path of least resistance, it is often complicated later by adjustments needed to reflect the business on a "stand-alone" basis. Also, the buyer typically places reduced creditability on unaudited financial statements. If management is unable to provide full, SEC-compliant carve-out financial statements, some types of abbreviated asset statements may be permitted with advance agreement of the SEC.

Defining "a business"

When determining whether to allow abbreviated financial information in an SEC filing, the SEC will consider whether the separated and sold entity is in fact a "business" or merely a set of assets. If costs cannot be identified or associated with the separated entity, the SEC may indicate that the buyer has acquired assets. Generally, asset acquisitions do not trigger the need to report historical audited financial statements in SEC filings, as acquisitions of businesses do.

However, determining what constitutes a business versus an asset in an acquisition is far from simple. To determine if a commercial operation constitutes a business for SEC reporting purposes, the SEC focus



is whether disclosure of prior financial information is material to an understanding of the acquired entity's future operations, based on continuity of those operations before and after the transaction. While an acquired subsidiary or division may clearly be a "business," determining the status of other components may or may not require professional judgment.

Accounting complexities

Sellers often underestimate the magnitude of effort required to prepare carve-out financial statements. The SEC requires that the statement reflect the parent company's accounting basis for the business to be separated (SAB 55). All carve-out-related adjustments – such as impairment or restructuring charges, purchase accounting adjustments and top-side entries – must be "pushed down." Other accounting complexities include third-party debt and/or intercompany debt, determining the capital structure for the carve-out entity and identifying the reporting segments for the carve-out.

If the financial statements must be audited, management should involve the auditors and other professional advisors in the process early on and make sure that the auditors concur with management's conclusions along the way. In addition, these other auditing matters are frequently encountered:

Auditors may need to reduce the carve-out's materiality levels compared to those used for the parent company's audit. Even if a reporting unit has been audited before, additional or expanded procedures may be needed.

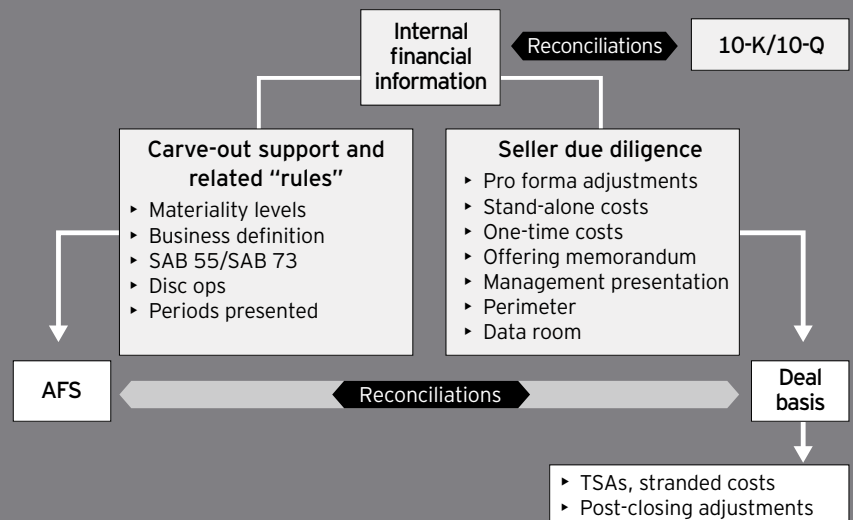
The auditor of the carve-out should get the parent company's views on the treatment of subsequent events.

If the business includes inventory and the auditors have not historically performed physical inventory counts for the business,



Audited financial statements (AFS) vs. bidder information

- ▶ In most instances, the carve-out financial statements do not represent the ultimate deal-based financials.
- ▶ The seller will need to address both the "rules" of a carve-out (definition of a business, SAB 55, etc.) and the "needs" (pro forma adjustments, stand-alone estimate, one-time costs, etc.) of the potential buyer.
- ▶ The carve-out audit and performing sell-side diligence of the business to be sold are commonly two separate workstreams that should be linked or bridged together throughout the divestiture process.
- ▶ Performing reconciliations between the historical, carve-out and deal basis financial statements adds transparency to the deal and provides comfort to the potential buyers that the information "holds together."



the auditors must observe inventory in the current period and perform “rollback” procedures during the historical periods.

Historical acquisitions by the carve-out may require audited financial statements subject to SEC significance tests.

Generating carve-out statements

No two carve-outs are alike. Rather than attempt to anticipate every possible issue that may arise, a better approach is to define a robust process using these guidelines:

- ▶ **Identify a carve-out project leader and team** – If knowledge of the transaction must be limited to a small group of people for reasons of confidentiality, there may be consequences for the project timeline. If the business includes operations abroad, it is best to identify carve-out coordinators in each country to identify local issues in a timely way. It is the leader’s role to make decisions and keep the project on schedule.
- ▶ **Determine what kinds of statements are needed** – Will the carve-out financial statements need to be audited and/or be SEC-compliant based on the seller’s situation or the probable needs of likely buyers? Firms must also consider what historical periods (annual,



- quarterly, trailing 12 months) will be included and in what order such information should be prepared. Some projected future costs usually need to be included.
- ▶ **Determine the scope and related complexity of the carve-out** – This includes developing the definition of the “business” being carved out and identifying the assets, liabilities and related operations to be included in the financial statements. If appropriate, consider SEC requirements to show how the defined business relates to the reporting company’s legal organization chart.
- ▶ **Identify the necessary financial data and their sources** – Necessary data includes previously reported statements, separate

general ledgers and sub-ledgers. This data typically becomes the basis for designating financial statement line item sources as directly attributed to the business.

- ▶ **Use care in allocating costs** – SEC-compliant carve-out financial statements must reflect all costs of doing business and, as specified in SAB 55, use a well-documented allocation methodology for costs that cannot be directly attributed to the business. Examples include interest expense, corporate overhead expenses and employee fringe benefits, including stock-based compensation. The allocation methodology must be reasonable and not overly complicated.
- ▶ **Use real-time, web-based tools that facilitate dynamic ongoing reporting** – Web-based tools make it easier to update and access data than do static tools such as spreadsheets. Establishing separate reporting modules for the parent organization and the carve-out allows for regular updates to buyers and frees the seller from having to repeatedly disentangle stand-alone data from integrated businesses. Current data will be required by buyers and lenders throughout the process, often long after the audited carve-out financial statements are issued.

- ▶ **Communicate with auditors** – Early and ongoing dialogue will speed the process of auditing and finalizing carve-out statements. The effort invested in up-front planning and communications will reduce the time needed to complete the audit and improve quality, often leading to a faster close. ▼

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