



Combined and/or carve-out financial statements



IFRS application guidance

April 2017

Contents

Important note	1	6 Practical considerations	75
About this publication	2	6.1 Project management	75
1 Introduction to combined and/or carve-out financial statements	4	6.2 IT systems and data gathering	76
1.1 Types of financial information	4	6.3 Central and shared services	78
1.2 Objective of combined and/or carve-out financial statements	7	6.4 Supporting documentation	79
1.3 Combined vs carve-out financial statements	7	6.5 Involvement of other functions	79
1.4 Types of transactions for which combined and/or carve-out financial statements are prepared	10	6.6 Internal controls	80
		6.7 Audit and reporting considerations	80
2 Boundaries of the reporting entity	13	Acknowledgements	83
2.1 Fit for purpose	13	Keeping in touch	84
2.2 Step 1: Are the components under common control?	15		
2.3 Step 2: Are all relevant economic activities included?	17		
3 Overall approach to preparing the financial statements	22		
3.1 Overview	22		
3.2 Commonly observed overall approaches	27		
3.3 Disclosure of accounting policies	30		
3.4 Continuity of financial information	31		
4 Accounting policies and estimates	35		
4.1 Implications of a separate combined/carved-out reporting entity	35		
4.2 Accounting treatment for related party transactions in combined and/or carve-out financial statements	36		
4.3 Estimates and compliance with IFRS	42		
4.4 Consolidation procedures	44		
4.5 Statement of financial position	44		
4.6 Statement of profit or loss and OCI	49		
4.7 Equity	53		
4.8 Other allocation and presentation issues	53		
5 Disclosures	62		
5.1 Boundaries of the reporting entity	62		
5.2 Overall approach to preparing the financial statements	67		
5.3 Accounting policies and estimates	70		

Important note

What's the issue?

Users and regulators often require companies to provide combined and/or carve-out financial statements because they can provide meaningful, relevant and useful information.

But answers to questions about combined and/or carve-out financial statements have not always proven to be intuitive and/or consistent around the globe. This makes the preparation of combined and/or carve-out financial statements challenging processes that require considerable judgement by management.

Why is there diversity in practice?

There isn't a specific IFRS that deals with combined and/or carve-out financial statements, so local practices have developed, often through discussions with regulators.

How will this guidance help?

This guidance aims to highlight practice where IFRS is applied consistently globally. It also aims to draw attention to those areas in which we have observed diversity in the application of IFRS.

General-purpose financial statements

Combined and/or carve-out financial statements may be considered general-purpose financial statements. However, there is a distinction between them and other general-purpose financial statements, such as financial statements of a legal entity or of an existing group. To make the distinction clear in this publication, general-purpose financial statements of a legal entity or of an existing group are referred to as 'generic financial statements'.

This terminology is not acknowledged in IFRS, but is used solely to make the distinction clear and prevent repetition in this practical guide.

Areas of application issues



This symbol highlights areas in which heightened awareness may be required; we recommend you consult your KPMG professional.

For these areas, we describe an approach(es) that we think would be more consistent with the principles of IFRS applied to generic financial statements, and highlight other approaches seen in practice.

Given the fact that IFRS does not address combined and/or carve-out financial statements, we recognise that in practice the application of accounting treatments for combined and/or carve-out financial statements may vary between jurisdictions. Some of the approaches we describe in this publication may be inappropriate based on specific regulatory requirements and/or would not be observed in practice in certain jurisdictions.

This publication has not been developed in contemplation for any specific jurisdiction or regulatory environment and therefore, we recommend consultation with your KPMG professional to understand the accepted practice(s) in your jurisdiction and any applicable local regulatory requirements or restrictions.

About this publication

Scope

The purpose of this publication is to provide guidance on the preparation of combined and/or carve-out financial statements that are based on historical data and prepared in accordance with IFRS.

As at April 2017, this material reflects our latest thinking and observations on this topic globally. The guidance in this publication is mainly based on our experience of the practice that has developed in applying IFRS to combined and/or carve-out financial statements in relation to relevant sections from *Insights into IFRS*.

Combined and/or carve-out financial statements that are not prepared in accordance with IFRS are not in the scope of this publication – e.g. those prepared in accordance with US GAAP or SIR 2000 *Investment Reporting Standards Applicable to Public Reporting Engagements on Historical Financial Information* in the UK.

Definition

In this publication, we generally use the term ‘combined and/or carve-out financial statements’ as a generic term meaning: a set of historical financial information comprising one or more economic activities that can be objectively distinguished from other economic activities within the larger reporting entity. These activities are typically under common control, do not comprise an existing legal entity or group and are presented as a single reporting entity.

This definition is supported by the fact that, although there is no specific guidance in the standards, the IASB has long acknowledged the principle that combined financial statements can comply with IFRS. For example, the *IFRS for SMEs* defines combined financial statements as ‘a single set of financial statements of two or more entities controlled by a single investor’ (paragraph 9.28).

This sentiment is reinforced by commentary included in the IASB’s May 2015 exposure draft *Conceptual Framework for Financial Reporting*, which proposes the following definition of combined financial statements: ‘financial statements prepared for two or more entities that do not have a parent-subsidiary relationship’ (paragraph 3.17). The accompanying basis for conclusions observes that combined financial statements may provide useful information in some circumstances, but that developing guidance on how to apply IFRS in such statements would be best undertaken in a project specific to that topic (paragraph 3.17 of the basis for conclusions). The definition proposed in the exposure draft encompasses the concept of carve-out financial statements, and is broader than the working definition used in this publication.

Combined vs carve-out financial statements

The terms 'combined financial statements' and 'carve-out financial statements' are often used interchangeably, or one or the other term is used exclusively in a certain jurisdiction.

For some combined financial statements – i.e. financial statements that represent the combination of two entities owned by the same individual – there is no larger reporting entity and therefore no financial information for a larger reporting entity available. However, the absence of a larger reporting entity does not in itself prevent a set of combined financial statements from being in compliance with IFRS.

For a further discussion of what distinguishes the two types of financial statements in some jurisdictions, see Chapter 1.3.

Regulatory requirements

This publication is not intended to address regulatory requirements in specific jurisdictions, although some examples are included for illustrative purposes. Therefore, it should also be used in conjunction with any relevant regulatory requirements.

Organisation of the text

References are included in the left-hand margin of this guide. Where relevant, the text is referenced to source material – primarily IFRS and the 13th edition 2016/17 of our publication [Insights into IFRS](#), but also SEC pronouncements in some cases.

<i>CFOB2</i>	Paragraph 2 of chapter 'Objective of general purpose financial reporting' in the <i>Conceptual Framework for Financial Reporting</i> .
<i>IAS 1.82(a)</i>	Paragraph 82(a) of IAS 1 <i>Presentation of Financial Statements</i> .
<i>SEC FRM 7410</i>	Section 7410 of the <i>Financial Reporting Manual</i> of the Division of Corporation Finance of the SEC.
<i>Insights 2.3.60.10</i>	Paragraph 2.3.60.10 of the 13th Edition 2016/17 of <i>Insights into IFRS</i> .

Abbreviations

The following abbreviations are used throughout this publication.

COSO	Committee of Sponsoring Organisations
FRM	Financial Reporting Manual of the Division of Corporation Finance of the SEC, which provides general guidance about SEC financial reporting and filing matters
IPO	Initial public offering
ISA	International Standard on Auditing
ISAE	International Standard on Assurance Engagements
M&A	Mergers and acquisitions
Newco	A newly formed entity, used to describe the entity that is formed and continues in existence post-transaction (if any)
OCI	Other comprehensive income
SEC	US Securities and Exchange Commission

1

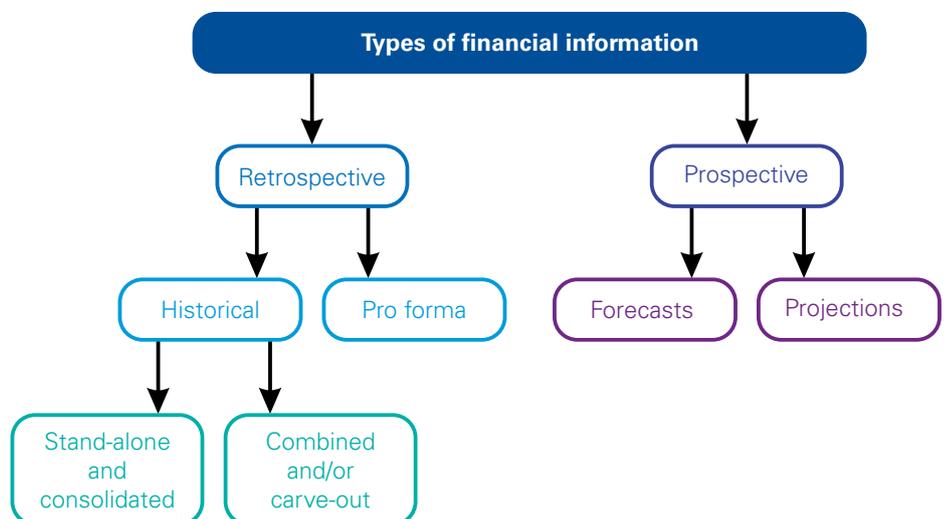
Introduction to combined and/or carve-out financial statements

1.1

Types of financial information

Financial information can be retrospective (past-looking) or prospective (forward-looking). Retrospective financial information is generally classified as either historical or pro forma. Historical information is based solely on past transactions or events. In contrast, pro forma information aims to illustrate how a consummated or proposed transaction (or event) might have affected the financial information presented in a prospectus or other document had the transaction occurred at an earlier date. Pro forma financial information does not represent a company's actual financial position or results – it addresses a hypothetical situation and is prepared for illustrative purposes only.

Offering documents, both regulated and unregulated, often include both types of information.



Type of information		Description
<i>IAS 27.4</i>	Stand-alone financial statements	A set of financial statements prepared for an individual legal entity, which are a structured representation of the financial position and financial performance of the entity. Referred to as 'separate' financial statements by a parent that has one or more subsidiaries.
<i>IAS 27.4</i>	Consolidated financial statements	A set of financial statements prepared for a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic activity.
	Combined and/or carve-out financial statements	A set of historical financial information comprising one or more economic activities that can be objectively distinguished from other economic activities within the larger reporting entity (if there is one). These activities are typically under common control, and do not comprise an existing legal entity or group but are presented as a single reporting entity (see Chapter 1.2).
<i>ISAE 3420</i>	Pro forma	Financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for the purposes of the illustration.
<i>ISAE 3400</i>	Forecast	Prospective financial information prepared on the basis of assumptions about future events that management expects to take place and the actions that management expects to take as at the date the information is prepared (best-estimate assumptions).
<i>ISAE 3400</i>	Projection	Prospective financial information prepared on the basis of: <ul style="list-style-type: none"> – hypothetical assumptions about future events and management actions that are not necessarily expected to take place; or – a mixture of best-estimate and hypothetical assumptions. <p>This information illustrates the possible consequences as at the date the information is prepared if events and actions were to occur (an 'as-if' or 'what-if' scenario).</p>

This publication focuses on the preparation of combined and/or carve-out financial statements that are based on historical data. A combined/carved-out reporting entity includes components that historically 'belonged' together during all periods presented. For a more detailed discussion on determining the boundaries of the reporting entity, see Section 2.



Example 1A – Historical vs pro forma financial information

Group R operates in the retail sector. On 1 July 2016, R acquires the retail operations of Group V.

Group V's historical financial statements for the retail operations

For the purpose of presenting the operations that are being disposed of to R, V prepares carve-out financial statements for the year ended 30 June 2016 that comprise only its retail operations. These financial statements are in effect a subset of V's consolidated financial statements – they present historical financial information about V's retail operations.

Group R's pro forma financial information

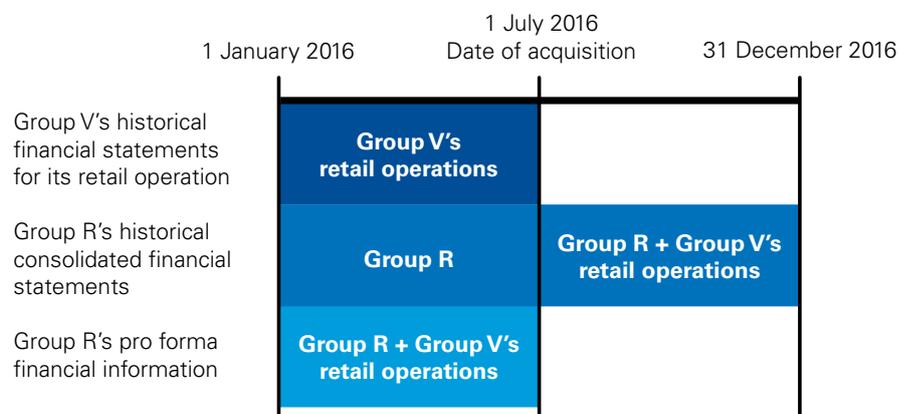
To illustrate the effect of the acquisition of V's retail operations, R prepares the following pro forma financial information as at 30 June 2016:

- a pro forma statement of profit or loss and OCI for the six months ended 30 June 2016 that includes V's retail operations from 1 January to 30 June 2016 as if they had been acquired on 1 January 2016; and
- a pro forma statement of financial position as at 30 June 2016 that includes V's retail operations as at 30 June 2016 as if they had been acquired on 30 June 2016.

Group R's historical financial information

R prepares consolidated financial statements over 2016, which include the retail operations as from the date of acquisition. The consolidated financial statements represent historical financial information.

The following diagram highlights the distinction between the historical and pro forma financial information in this example.



1.2

CF.OB2, QC1–QC30

Objective of combined and/or carve-out financial statements

If financial information is to be useful to investors, lenders and other creditors, then it needs to be relevant and faithfully represent what it purports to represent. Its usefulness is enhanced if it is comparable, verifiable, timely and understandable. However, because combined and/or carve-out financial statements are not currently defined in IFRS, and IFRS does not provide any specific guidance on their preparation,¹ significant judgement is needed, based on the purpose for which the financial statements are being prepared, to ensure that they meet the objective of providing useful information.

Combined and/or carve-out financial statements provide financial information about one or more of the economic activities that are part of a larger reporting entity. We have observed that the components of these statements can include subsidiaries, divisions, branches and/or an aggregation of all similar assets, associated liabilities and operations in a specified geographic region or line of business. They may have separate management and accounting records, but they could also have management, expenses and other resources in common with other components of the larger reporting entity. The components are typically under common control for all periods presented (see Chapter 2.2).

1.3

Combined vs carve-out financial statements

The appropriate identification and labelling of a set of financial statements as either 'combined' or 'carve-out' may depend on the jurisdiction. In jurisdictions that make a distinction between the terms, the difference usually arises from the nature of the individual components from which the financial statements are drawn.

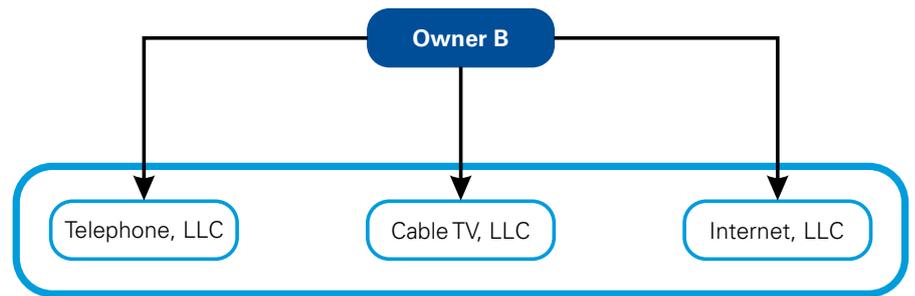
- *Combined financial statements*: The combination of two or more legal entities or businesses that may or may not be part of the same group, but do not by themselves meet the definition of a group under IFRS 10 *Consolidated Financial Statements* – i.e. a parent and all of its subsidiaries. At a simplistic level, preparing combined financial statements involves adding together two or more legal entities and eliminating any inter-company transactions – e.g. inter-company profits, revenue and expenses, receivables and payables and equity (e.g. unrealised gains and losses).
- *Carve-out financial statements*: Financial statements that include one or more components that are parts of a larger reporting entity. The term 'carve-out' reflects the fact that smaller components – e.g. unincorporated businesses such as divisions – are being carved out from a larger reporting entity.

1. The IASB's May 2015 exposure draft *Conceptual Framework for Financial Reporting* included a definition of combined financial statements. The IASB's staff summary of January 2017 showed that the definition has not changed in the course of the Board's redeliberations on the exposure draft. However, the revised *Conceptual Framework* has not been finalised and therefore is not effective yet.



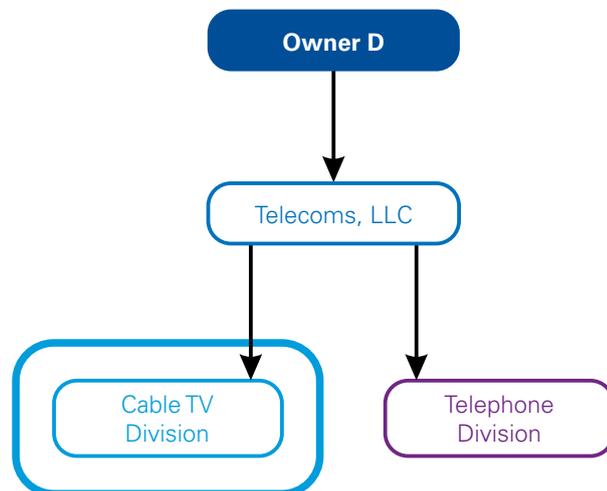
Example 1B – Combined financial statements

Owner B has three separate businesses comprising separate legal entities that each prepare stand-alone financial statements. B 'combines' the stand-alone financial statements into a single set of combined financial statements in preparation for an IPO.

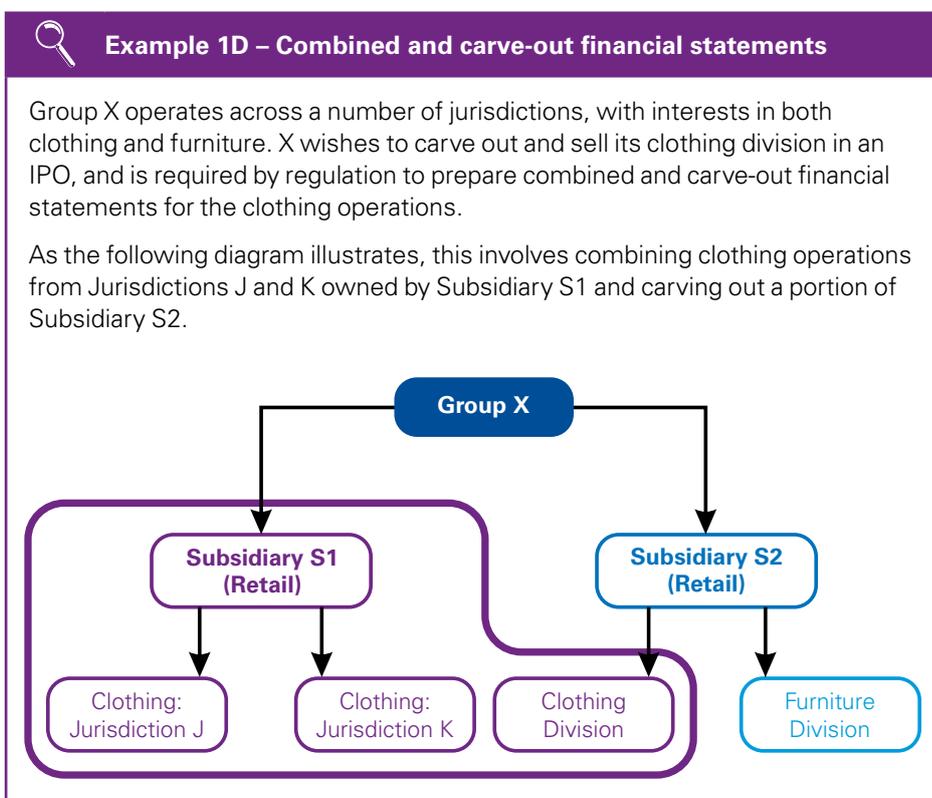


Example 1C – Carve-out financial statements

Owner D has a cable and telephone business that is part of a single legal entity. D 'carves out' the cable division into a set of carve-out financial statements in preparation for an IPO.



Combined and carve-out financial statements are not mutually exclusive. As the following example illustrates, it is common to have elements of both. In these cases, the financial statements might also be referred to as 'combined and carve-out' financial statements.



The following table describes the characteristics that are usually found in combined or carve-out financial statements when a distinction is made.

Factor	Combined financial statements	Carve-out financial statements	Chapter
Based on historical financial information	Yes	Yes	1.1
Consists solely of whole legal entities	Yes	Generally, no – consists of smaller components of a larger reporting entity	1.3
Typically under common control throughout the period being reported on	Yes	Yes	2.2

Factor	Combined financial statements	Carve-out financial statements	Chapter
Each component has its own (separate) accounting records and processes that have enabled it in the past to prepare stand-alone financial statements	Yes	Generally, no. However, certain financial metrics – e.g. revenue, operating profit, net income – may have generally been tracked historically for internal reporting purposes	2.3
The entities could operate as stand-alone businesses with little or no assistance from the parent entity/owners	Generally, yes	Generally, no – need additional support from parent/owners	4.1
Extent of allocations necessary to prepare the financial statements	Allocations generally not pervasive	Allocations vary	4.2 and 4.3

1.4 Types of transactions for which combined and/or carve-out financial statements are prepared

IFRS financial statements are frequently used in capital market transactions to present the economic activities of an issuer in a prospectus. However, in many cases the issuer's legal structure is changed and customised specifically for the planned transaction. As a result, historical financial information based on the legal entity or existing group may not be sufficient to appropriately represent the economic activities of the reporting entity that will be formed after the transaction.

In these circumstances, it is often required or desirable to prepare another type of historical financial information instead: financial statements based on an economic perspective. The objective of combined and/or carve-out financial statements is to present aggregated historical financial information of components that have not in the past represented a reporting entity. These financial statements may be necessary to facilitate various transactions, including:

- an IPO: e.g. for a group of divisions;
- a spin-off: e.g. of a group of divisions; or
- private M&A transactions: i.e. acquisitions and disposals, for either (net) asset(s) or share deals.

1.4.10

Required by regulation

In many jurisdictions, combined and/or carve-out financial statements are required or permitted by regulation. The following are examples.

- The *EU Prospectus Regulations* set out a framework for the preparation and publication of a single prospectus throughout Europe. This means that a prospectus approved in one country may be used in another. However, it leaves responsibility for the implementation of detailed regulations to the member states.

In accordance with the *EU Prospectus Directive*, an issuer may be required by a national authority to present combined and/or carve-out statements when it:

- makes an offer to the public of shares;
- issues other transferable securities equivalent to shares or other securities that can be converted;
- exchanges transferable equivalent securities into shares under certain circumstances; or
- asks for the admission of its securities to trading on a regulated market.

The same applies to the issue of debt, although there are no explicit legal requirements. Nonetheless, in some situations combined and/or carve-out financial statements may be useful for some investors.

- In the *US*, combined and/or carve-out financial statements have been prepared for decades for the purposes of capital market transactions based on regulatory requirements. Common scenarios include IPOs that are arranged as ‘put-together transactions’ or ‘roll-up transactions’ for which either SEC Form S-1 or F-1 is filed with the SEC. In put-together transactions, two or more parties transfer net assets to a Newco in exchange for shares in that reporting entity; in roll-up transactions, an investor (usually from the private equity or alternative investment sector) acquires two or more smaller businesses from the same sector and merges them into a Newco. The SEC has issued several pronouncements that address combined and/or carve-out financial statements for these scenarios. In addition, for the purpose of ad hoc reporting in conjunction with significant acquisitions by SEC registrants in accordance with *SEC Regulation S-X 3-05*, combined and/or carve-out financial statements prepared on the basis of IFRS might be reported under certain circumstances.
- In *Hong Kong*, it is common practice for companies seeking a listing to carry out a reorganisation of the proposed combined and/or carved-out listed components before listing. Under the *Hong Kong Listing Rules*, all listing candidates have to present historical financial statements of the proposed combined and/or carved-out listing components for the track record period. If the reorganisation takes place after the end of the track record period and involves a Newco acquiring companies or businesses that, together with the Newco, are held under common control and form the proposed combined or carved-out listing group, then the historical financial statements are normally presented on a combined basis.
- In *Canada*, in accordance with the *Companion Policy to National Instrument 41-101 (General Prospectus Requirements)*, the financial statements of the primary business of the issuer have to be provided. The ‘primary business’ typically includes the newly acquired significant acquisition, which is generally reflected in combined and/or carve-out situations. This

Companion Policy references the guidance in the *Companion Policy to National Instrument 51-102 (Continuous Disclosure Obligations)* for the requirements on combined and/or carve-out basis financial statements.

- In *Mexico*, under the Mexican *National Banking and Securities Commission Rules*, all companies seeking a listing on the Mexican Stock Exchange have to present historical financial statements of the proposed combined and/or carved-out listing components for the relevant required periods (i.e. three years of historical financial statements). If the reorganisation of the legal entities or combined and/or carved-out components takes place before or simultaneously with the IPO transaction, then the historical financial statements are normally presented on a combined/carved-out basis.

1.4.20

Unregulated

Private contracts in connection with M&A transactions are among the most common scenarios for which combined and/or carve-out financial statements are prepared. These include, for example, sales of a part of a business in the form of controlled auctions or private placements. These transactions may take place outside the regulatory environment if the entities involved are not subject to regulatory requirements – e.g. because neither of the entities has shares traded on public markets.

In some jurisdictions, mostly within the EU and US, an entity can also issue financial instruments in private placements on non-regulated ‘open markets’, which in contrast with a public offering or the admission of securities to trading on a regular market, might not be subject to regulatory review. However, combined and/or carve-out financial statements might still be included for the business(es) subject to the transaction.

The following are other examples of unregulated transactions for which combined and/or carve-out financial statements might be prepared.

- A bank issues a loan to legal entities within a group that is secured by asset pledges or guarantees. In addition to a set of consolidated financial statements prepared by the parent, the bank may request combined and/or carve-out financial statements for the subgroup of legal entities of the group that actually receive the loan.
- Individuals (or members of a family) could personally hold majority interests in two or more entities, so that these interests are not bundled in a group holding entity that would be required to prepare consolidated financial statements. These individuals may be interested to receive financial information on a combined basis.

2

Boundaries of the reporting entity

2.1

Fit for purpose

In preparing combined and/or carve-out financial statements, the reporting entity is tailored to meet the specific purpose for which the financial statements are being prepared, and does not have to constitute an existing legal entity or group; it may become a legal entity or group on completion of the transaction (if there is one). Therefore, the determination of the boundaries of the reporting entity for combined and/or carve-out financial statements can be complex and often requires more judgement than for generic financial statements.

To determine the boundaries, management needs to consider the overarching question of whether the combined and/or carve-out financial statements are fit for the intended purpose. This question underlying the determination of the boundaries of the reporting entity is essential because it is the decisive element in whether information is useful to potential and existing investors, lenders and regulators (where applicable).

To be fit for purpose, the combined and/or carve-out financial statements need to portray the reporting entity consistently with the purpose for which they are prepared. This may depend on a variety of aspects, including the following qualitative factors:

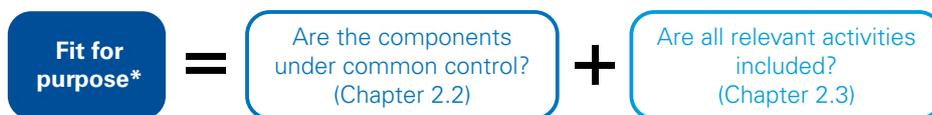
- the reason why the financial statements are being prepared;
- the information intended to be conveyed;
- the expected users;
- consistency of the combined/carved-out reporting entity with the post-transaction reporting entity (particularly in the case of an IPO); and
- the markets in which the financial statements will be released and the related legal and regulatory requirements.

In determining whether it is practicable for management to prepare combined and/or carve-out financial statements that comply with IFRS, management assesses the extent to which the entity is able to separate each component's financial performance and assets/liabilities from those of the larger reporting entity (see Chapter 4.3).

The following are two key elements that management needs to consider, in addition to the qualitative factors set out above, when determining whether the boundaries of a reporting entity are set so that they will result in financial statements that are fit for purpose.

1. Are the components under common control during the reporting period included in the combined and/or carve-out financial statements?²
2. Are all relevant activities included?

2. These transactions are typically under common control; however, other practices have been observed. See Chapter 2.2 for more guidance.

**Note**

* This diagram is a paradigm (i.e. not considered to be a mathematical formula). Whether the combined/carved-out reporting entity is fit for purpose depends on a variety of aspects, including qualitative factors, the two key elements included and other relevant aspects.

Although all factors are relevant in a variety of cases, the assessment is typically more straightforward when the combined and/or carve-out financial statements:

- are included in a registered offering and the related regulations have specific requirements for their content; or
- are being used to effect a private M&A transaction on the basis of a (draft) purchase-and-sale agreement and the components of the financial statements are identified on the basis of defined economic characteristics.

Although there is no specific guidance on determining the boundaries of a reporting entity, the following terms that are used in IFRS may be useful in determining the boundaries of the reporting entity based on the purpose of the financial statements.

	Term	Definition
	Legal entity	There is no formal definition of what constitutes a legal entity under IFRS, and definitions may vary by jurisdiction. However, a legal entity generally has a legally enforceable ability to enter into a contractual agreement and assume the obligations necessary to operate a business or engage in start-up operations. Legal entities can take various forms, including corporations, partnerships, joint ventures, proprietorships and trusts.
<i>IFRS 3.A</i>	Business**	An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.
<i>IFRS 10.A</i>	Group	A parent and its subsidiaries.
<i>IFRS 10.A</i>	Subsidiary	An entity that is controlled by another entity (i.e. its parent).
<i>IFRS 10.A</i>	Consolidated financial statements	Financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic activity.
<i>IAS 27.4</i>	Separate financial statements	Financial statements presented by a parent or an investor with joint control of, or significant influence over, an investee. An entity is allowed to choose one of the following accounting policies to account for interests in subsidiaries, associates and joint ventures, unless they are classified as held-for-sale:

Term	Definition
IFRS 5.32 Separate financial statements (continued)	<ul style="list-style-type: none"> – at cost; – using the equity method as described in IAS 28 <i>Investments in Associates and Joint Ventures</i>; or – in accordance with IAS 39 <i>Financial Instruments: Recognition and Measurement</i>.
IFRS 8.5 Discontinued operations	<p>A component of an entity that either has been disposed of or is classified as held-for-sale and:</p> <ul style="list-style-type: none"> – represents a separate major line of business or geographic area of operations; – is part of a single co-ordinated plan to dispose of a separate major line of business or geographic area of operations; or – is a subsidiary acquired exclusively with a view to resale.
IFRS 8.5 Operating segment	<p>A component of an entity:</p> <ul style="list-style-type: none"> – that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity); – whose operating results are regularly reviewed by the entity’s chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and – for which discrete financial information is available.
IAS 36.6 Cash-generating unit	<p>The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.</p>
Note	
<p>** In June 2016, the IASB published the exposure draft <i>Definition of a Business and Accounting for Previously Held Interests – Proposed Amendments to IFRS 3 and IFRS 11</i>. The proposed amendments aim to provide clearer application guidance to distinguish between a business and a group of assets when applying IFRS 3 <i>Business Combinations</i> and how an entity should account for a previously held interest in a business, if acquiring control or joint control of that business.</p>	

2.2 Step 1: Are the components under common control?

In order to prepare combined and/or carve-out financial statements, all components included in the combined and/or carve-out financial statements are typically under common control throughout the entire reporting period(s) presented.

Insights 5.13.10.10

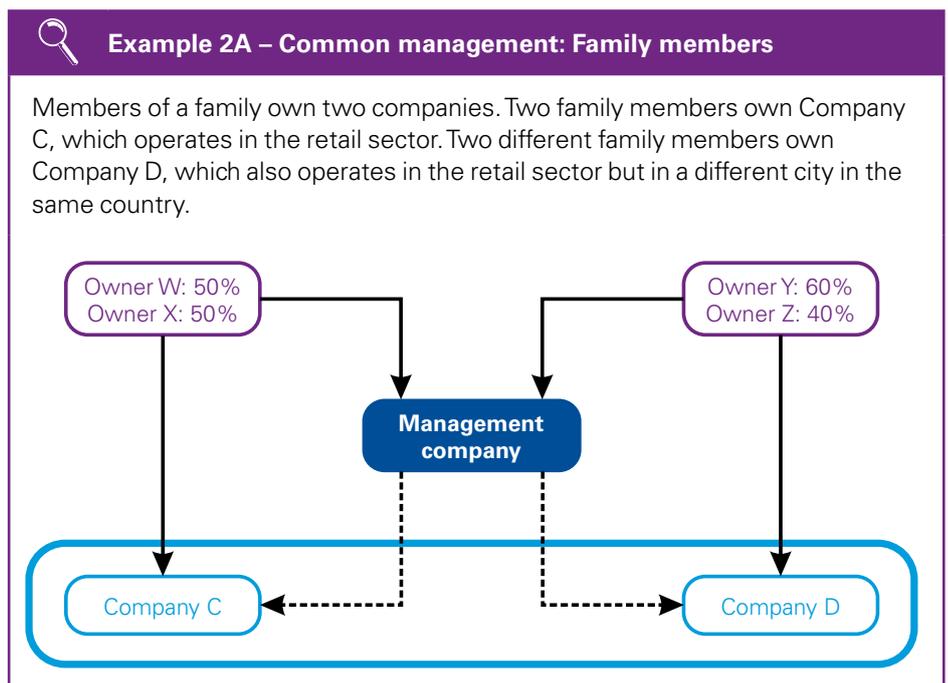
A ‘business combination involving entities or businesses under common control’ is a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the combination, and that control is not transitory. Further guidance on what constitutes common control is included in 5.13.10 in *Insights into IFRS*.

IFRS 3.B1

For generic financial statements, the application of any guidance on common control is restricted to entities under common control and not extended further to entities under common management. However, we have observed that in practice, in limited circumstances and in certain jurisdictions, combined and/or carve-out financial statements are being presented for entities under common management. These financial statements include entities that were not under common control but were under common management for all periods presented in the financial statements.

The determination of whether combined and/or carve-out financial statements for entities under common management are appropriate is a matter of judgement taking into account the purpose of the financial statements and any regulatory requirements, as well as whether there is a rational basis for their preparation and the need to ensure that the information conveyed by the financial statements is not misleading.

We recommend that you research common practice in your jurisdiction, to ensure that you understand the predominant practice in the jurisdiction, because the boundaries of the reporting entity may differ significantly depending on whether the application of a common management rationale is appropriate.



All of the day-to-day decisions for both companies are made by the family management company, and decisions made by the management company affect both companies. The management company does not consolidate C and D.

The family members plan to list a Newco that will hold the shares in C and D. For this purpose, the family plans to prepare combined financial statements that include both companies. In this example, it may be reasonable to conclude that common management, without common control, is a sufficient basis on which to prepare combined financial statements, assuming that the other criteria are met (see Chapter 2.1).

For further discussion of when family relationships result in common control, see 5.13.10.40–50 in *Insights into IFRS*.

For an example of the basis of preparation of a set of combined and/or carve-out financial statements prepared on the basis of common management, see Disclosure 5C in Section 5.

2.3

Step 2: Are all relevant economic activities included?

Combined and/or carve-out financial statements comprise one or more economic activities that can be objectively distinguished from other economic activities within the larger reporting entity. There is no specific definition of 'economic activities' in IFRS, and a final determination will depend on regulations in the relevant jurisdiction and/or the judgement of management assessed against the purpose for which the financial statements are being prepared. This assessment includes whether the appropriate assets, associated liabilities and operations have been included in each component of the reporting entity, as well as an assessment of whether the combined and/or carve-out financial statements are complete.

Whether it is appropriate to include or exclude components from combined and/or carve-out financial statements often depends on whether the purpose of the financial statements is to display management's track record. For example, for an IPO without a change in management (i.e. the same management before and after the IPO for the business being carved out), information on management's track record may be relevant and useful for investors; therefore, the inclusion of all relevant activities may be necessary. Conversely, for a private M&A transaction in which a seller and buyer of identified economic activities have determined in the purchase-and-sale agreement the exact net assets to be transferred, the combined and/or carve-out financial statements typically exclude activities and related assets and liabilities that will not be transferred to the buyer. The track record of management may not be relevant in this circumstance.

In some cases, the approach elected depends on the requirements of specific laws or regulations, or the views of regulators, in the jurisdiction(s) in which an offering document will be filed or the transaction is taking effect.

Being able to isolate economic activities for the purpose of preparing the financial statements is important for a final determination of whether the financial statements can comply with IFRS (see Chapter 4.1) and whether they are fit for the intended purpose.

Given that the determination of whether all relevant economic activities are included is highly dependent on the specific facts and circumstances, no specific approach can be prescribed. However, based on our general observations the following factors are used in practice to assess whether economic activities can be distinguished for the purpose of preparing a set of combined and/or carve-out financial statements.

Factor	General observation
Independent cash inflows	Generally, an economic activity has independent cash inflows, which are separate and distinct from other streams of cash inflows and might be a factor to distinguish the economic activity.
Shared assets	Different sets of economic activities have limited shared assets, other than shared facilities such as a corporate office. For example, if a single piece of equipment is used to produce two similar products, then the economic activities may not be distinguished, even if the two products have independent cash inflows. In this example, the equipment is being used for the same general purpose.
Common costs	There are minimal shared costs between different sets of economic activities. Distinct economic activities have no more than incidental common facilities and costs.
Management	The day-to-day activities of different sets of economic activities are managed independently of one another – i.e. each economic activity has historically been managed as if it were autonomous.
Nature of product or service	A set of economic activities can be distinguished by the type of end product or service, use of the product or service, customer base, pricing, costs and/or brand.
Geography	Geography is not generally a factor in determining the scope of an economic activity.
Post-combined operations	After the transaction for which the combined and/or carve-out financial statements are being prepared, dissimilar economic activities will be operated, managed and financed separately.

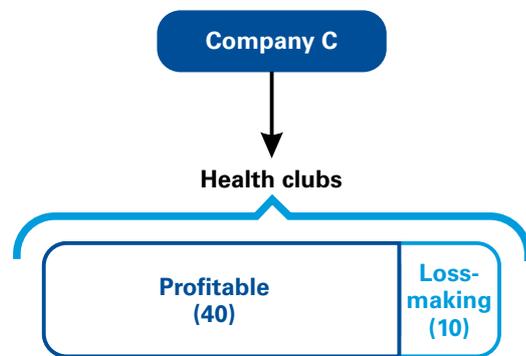
The above factors are guidelines with no particular weighting, and as such are not intended as 'bright lines'. Consideration of the above factors will vary, depending on the purpose for which the combined and/or carve-out financial statements are being prepared.

See examples of the disclosure of the economic activities that are included in the combined/carved-out reporting entity in Chapter 5.1.

Example 2B – Management’s track record

Company C has 50 health clubs that operate under a recognisable brand with operations throughout Country Y. The health clubs are all owned and managed centrally by the company and all operate under the same criteria – i.e. all have the same theme, fitness classes, price structure, prime locations, customer base etc. The health clubs and central management comprise one legal entity.

Of the 50 health clubs, 10 have historically been loss-making whereas the other 40 have been extremely successful. The reasons for the 10 health clubs underperforming vary and can be attributed in part to competition and poor on-site management.



C plans to raise additional capital to allow for expansion of the business both in and outside Y via an IPO through a spin-off. C plans to list only the 40 successful health clubs, which will be transferred to a Newco ahead of the IPO.

For the purposes of the IPO, management is required by local regulations to prepare a set of carve-out financial statements that provide investors with information to evaluate the strength of the brand and the overall track record of management. The financial information intended to be conveyed in the carve-out financial statements is the historical financial performance of all clubs. As such, the reporting entity to be included in the carve-out financial statements will include all relevant activities that have been a part of the history of the business and that can be expected to continue as the business after the IPO.

The assessment of common control as outlined in Step 1 concludes that common control exists. The following factors are used to assess how the business is run and whether all relevant activities are included.

Independent cash inflows	Each health club has independent cash inflows.
Shared assets	The health clubs do not have shared assets.
Common costs	The health clubs have minimal shared costs.
Management	The health clubs have central management, which results in the clubs being operated by the same management team.
Nature of product or service	The health clubs have the same theme, fitness classes, price structure, prime locations, customer base etc.
Post-combined operations	After the IPO, the 40 successful health clubs will be managed separately from the 10 loss-making health clubs.

In this example, the economic activities of the 10 unsuccessful health clubs cannot be distinguished from those of the 40 successful health clubs. All of the health clubs are under the same brand, offer the same products and are operated by the same management team. The carve-out financial statements intend to portray the historical financial performance of all clubs. Therefore, in consultation with the regulator, management concludes that excluding the 10 unsuccessful health clubs would not provide useful information to the financial statement users about management's track record because it would not include all relevant activities.

Accordingly, management concludes that it would be inappropriate for the reporting entity to include only the successful health clubs and exclude the unsuccessful health clubs. Such an approach would not provide more relevant information to financial statement users going forward, because it cannot be expected that all new health clubs will be successful.

For a discussion of the presentation and measurement of components of combined and/or carve-out financial statements that will not be part of the business going forward – e.g. the 10 unsuccessful health clubs in this example – see 4.8.10.



We understand that some regulators, in similar circumstances, specifically require the exclusion of the operations that will not be part of the business going forward. Applying this requirement in the example above, the carved-out reporting entity would include only the 40 successful health clubs and exclude the loss-making operations.

This approach would not be consistent with the application of IFRS to generic financial statements. We recommend that you research common practice in your jurisdiction before proceeding with combined and/or carve-out financial statements that exclude economic activities that cannot be distinguished from the operations that are included in the combined/carved-out reporting entity, to understand accepted practice in the jurisdiction.

3 Overall approach to preparing the financial statements

3.1



Overview

The chosen overall approach should be appropriate for the purpose of the financial statements. This chapter provides an overview of the overall approaches commonly used to prepare combined and/or carve-out financial statements.

Globally, several approaches have been observed that have been applied to combined and/or carve-out financial statements. Although not all of them are consistent with the principles of IFRS for generic financial statements, all described approaches may have some technical merit for the purposes of combined and/or carve-out financial statements, depending on the specific facts and circumstances.

In general, there are two key decisions that management needs to make about the overall approach before preparing combined and/or carve-out financial statements:

- whether the combined/carved-out reporting entity will be a first-time adopter of IFRS and, if yes, how IFRS 1 *First-time Adoption of International Financial Reporting Standards* will be applied; and
- whether the combined and/or carve-out financial statements will be extracted from the consolidated financial statements of the larger group (if a larger group exists) to which the combined/carved-out reporting entity belongs (top-down approach) or built up from the financial statements of the entities or components that are being combined or carved out (bottom-up approach).

Although the primary decision is typically whether to use a top-down or bottom-up approach, these decisions are not independent, which means that management's decision-making process can be complex. A more in-depth discussion follows in Chapter 3.2, providing background information that is relevant to deciding on the approach.

3.1.10

The application of IFRS 1

An entity is required to apply IFRS 1 in its first IFRS financial statements – these are the first annual financial statements in which the entity adopts IFRS by an explicit and unreserved statement of compliance with IFRS. Guidance on the application of IFRS 1 is contained in Chapter 6.1 of *Insights into IFRS* and is not repeated here except for the issues discussed below.

References in this publication to an entity that prepares its financial statements in accordance with IFRS mean an entity that also distributes those financial statements to the entity’s owners or any other external parties – i.e. it has adopted IFRS as envisaged in IFRS 1.

The following example highlights the key terms used in applying IFRS 1.

Example 3A – Key terms on first-time adoption

Company X plans to present its first IFRS financial statements for the year ended 31 December 2016 – i.e. X will be a first-time adopter of IFRS in 2016. X will present one year of comparative information. The following diagram illustrates the key dates and periods in relation to X’s adoption of IFRS.

The diagram is a horizontal timeline with three key dates: 1 January 2015, 31 December 2015, and 31 December 2016. A dark blue bar spans from 1 January 2015 to 31 December 2015, labeled 'IFRS comparatives'. A lighter blue bar spans from 31 December 2015 to 31 December 2016, labeled 'First IFRS financial statements/first IFRS reporting period'. Below the timeline, the date 1 January 2015 is associated with 'Date of transition/opening IFRS statement of financial position', and 31 December 2016 is associated with 'First annual IFRS reporting date'.

In this diagram, X is presenting only one year of comparative information on the basis of IFRS, and therefore has a date of transition of 1 January 2015.

IFRS requires comparative information to be presented for at least one previous reporting period, but does not prohibit the presentation of more than one year of comparative information. The first-time adopter’s date of transition is at the start of the earliest comparative period presented on the basis of IFRS.



In our experience, there is diversity over whether the combined/carved-out reporting entity is considered to be a first-time adopter of IFRS. In some jurisdictions, a combined/carved-out reporting entity is always considered to be a first-time adopter of IFRS because this entity did not previously issue IFRS financial statements. Accordingly, the combined and/or carve-out financial statements are the combined/carved-out reporting entity’s first IFRS financial statements.

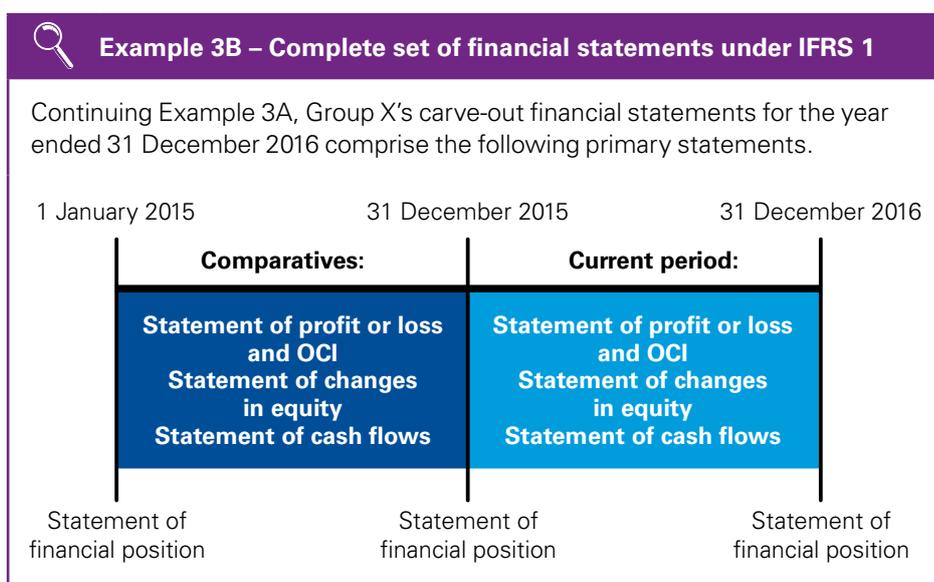
However, we have also observed in other jurisdictions that a combined/carved-out reporting entity is treated as a part of the larger reporting entity, which has already issued IFRS financial statements. Therefore, because the combined/carved-out reporting entity is already reflected under IFRS in the financial statements of the larger reporting entity, it is not considered to be a first-time adopter.

IFRS 1.6, 21

Presentation and disclosure

An entity's first IFRS financial statements include presentation of the opening statement of financial position. Therefore, an entity in its first IFRS financial statements presents at least three statements of financial position:

- as at the first annual IFRS reporting date;
- as at the previous annual reporting date; and
- as at the date of transition.



In addition to presenting a third statement of financial position as at the date of transition, IFRS 1 also requires the presentation of 'related notes'. This requirement should be interpreted as requiring disclosure of those notes that are relevant to an understanding of how the transition from previous GAAP to IFRS affected the first-time adopter's financial position at the date of transition – i.e. not all notes related to the opening statement of financial position are required in every circumstance.

Insights 6.1.1540.20

A first-time adopter might approach its decision about the relevant note disclosures by first assuming that all notes are necessary and then considering which note disclosures are not relevant to an understanding of the effect of the transition to IFRS and may be omitted. In deciding which notes and other comparative information to omit, the entity considers materiality and the particular facts and circumstances of the first-time adopter, including legislative and other requirements of the jurisdiction in which the first-time adopter operates.

Guidance on the presentation and disclosure relevant to a first-time adopter of IFRS is included in Chapter 6.1 in *Insights into IFRS*.

Reconciliations

IFRS 1.23–25

Extensive disclosures are generally required in an entity’s first IFRS financial statements to explain how the transition from previous GAAP to IFRS affected the reported financial position, financial performance and cash flows of the first-time adopter. These disclosures include reconciliations of equity and reported profit or loss at the date of transition and at the end of the latest period presented in the entity’s most recent annual financial statements in accordance with previous GAAP.

IFRS 1.28

These reconciliations are not required in combined and/or carve-out financial statements if there are no equivalent financial statements that have been published under previous GAAP for the reporting entity with which the IFRS financial statements can be compared.

3.1.20

Top-down vs bottom-up approaches

The following examples explain the concepts of the top-down and bottom-up approaches.

Example 3C – Top-down approach

Group X is a consumer markets group that is planning an IPO to sell its clothing operations, which are partly held in two subsidiaries and partly held in a division that is not a separate legal entity. As part of the mandatory listing documents for the planned IPO, X will prepare carve-out financial statements for the clothing operations.

```

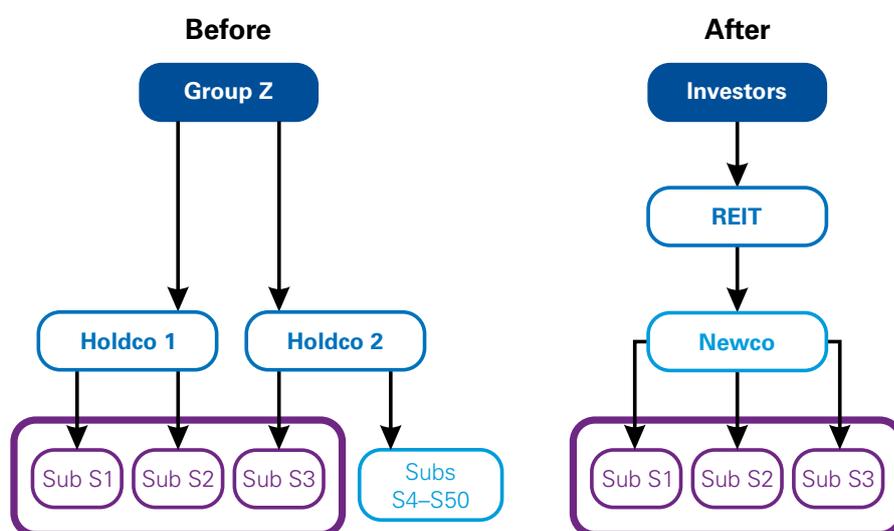
graph TD
    GX[Group X] --> S1[Subsidiary S1 (Retail)]
    GX --> S2[Subsidiary S2 (Retail)]
    S1 --> CJJ[Clothing: Jurisdiction J]
    S1 --> CKK[Clothing: Jurisdiction K]
    S2 --> CD[Clothing Division]
    S2 --> FD[Furniture Division]
    subgraph Clothing_Operations
        CJJ
        CKK
        CD
    end
    
```

X decides to prepare the financial statements by extracting the financial information for the clothing operations from its consolidated financial statements – i.e. a top-down approach. This means that the carrying amounts recognised by the larger reporting entity in its consolidated financial statements for the clothing operations will be included in the carve-out financial statements.

Example 3D – Bottom-up approach

Group Z holds an extensive portfolio of investment properties in Country Y. Each property is held in a separate company (Subsidiaries S1 to S50), which has independent operations and prepares its own financial statements. Z also prepares consolidated financial statements.

Z intends to list three of its subsidiaries (S1–S3) in an IPO of a new real estate investment trust (REIT). As part of the preparation for the IPO, Z transfers the shares in the related companies to a Newco.



As part of the listing documents, Z is required to present combined financial statements for the three property companies (sometimes referred to as the 'underlying financial statements').

Z decides to prepare the financial statements by combining the financial statements of Subsidiaries S1, S2 and S3 – i.e. a bottom-up approach. This means that any effects from applying acquisition accounting at the level of S1, S2 or S3 (i.e. to the extent that any of these subsidiaries have their own subsidiary-investees) will be retained in the combined financial statements.

However, any effects from applying business combination accounting at the level of Holdco 1 or Holdco 2 are not carried over into the combined reporting entities, regardless of how they have been kept for bookkeeping or other internal purposes in the past.

In determining whether to use the top-down or bottom-up approach, it is necessary to consider whether IFRS financial statements from the larger reporting entity are available. They might be available because the larger reporting entity has issued financial statements in compliance with IFRS.

Further, management needs to consider the requirements or preferences of any relevant regulator, common practice in the region or jurisdiction in which the combined and/or carve-out financial statements will be filed or used and other available relevant information.

3.2

Commonly observed overall approaches

This chapter outlines approaches to preparing combined and/or carve-out financial statements that in our experience are commonly used.

3.2.10 focuses on the approaches used if the combined/carved-out reporting entity is considered to be a first-time adopter of IFRS, and 3.2.20 describes the overall approaches if it is not considered a first-time adopter of IFRS.

The approaches discussed here are those most commonly seen in practice. We recommend researching common practice in your jurisdiction before selecting an approach.



3.2.10

Combined/carved-out reporting entity is a first-time adopter of IFRS

Around the globe, the following approaches are the most common for a combined/carved-out reporting entity that is considered a first-time adopter of IFRS.

The two approaches use the guidance in paragraph D16 of IFRS 1 for the combined/carved-out reporting entity when a subsidiary becomes a first-time adopter later than its parent.

IFRS 1.D16

The combined/carved-out reporting entity is treated as the subsidiary mentioned in paragraph D16, and the guidance in paragraphs D16(a) or D16(b) is applied to it. This means that the subsidiary may measure its assets and liabilities at the date of transition at either:

IFRS 1.D16(a)

- the amounts included in the consolidated financial statements of the parent, based on the parent's date of transition, *excluding* the effects of consolidation procedures and the business combination in which the parent acquired the subsidiary; or

IFRS 1.D16(b)

- the carrying amounts required by IFRS 1 based on the subsidiary's own date of transition.

In some cases, there might be no difference between these two approaches, because there are no adjustments recorded in the consolidated financial statements of the parent.

The following paragraphs discuss these approaches in more detail.

Financial statements prepared applying paragraph D16(a) of IFRS 1

To apply paragraph D16(a) of IFRS 1 to combined and/or carve-out financial statements, the larger reporting entity needs to have issued IFRS-compliant financial statements.

IFRS 1.D16(a)

When using paragraph D16(a), the relevant IFRS financial information for the combined/carved-out reporting entity is extracted from the financial statements of the larger reporting entity. The combined and/or carve-out financial statements are based on the parent's date of transition *excluding* the effects of consolidation procedures and the business combination in which the parent acquired the subsidiary – e.g. goodwill.



However, it has been observed that some combined and/or carve-out financial statements following this approach *include* the effects of the business combination in which the parent acquired the subsidiary that is a component of the combined and/or carve-out reporting entity, including goodwill. The rationale for including the goodwill is that an exclusion of goodwill or fair value adjustments would lead to an incomplete set of financial statements for the combined/carved-out reporting

entity, because they would not reflect all of the costs and resources controlled by the business. If the goodwill were excluded from the combined/carved-out reporting entity, then the combined and/or carve-out financial statements may not be as relevant and/or useful for the users of the financial statements.

This approach would be considered inconsistent with IFRS for generic financial statements.



Example 3E – Financial statements prepared applying paragraph D16(a) of IFRS 1

Modifying Example 3C, Group X concluded that it would prepare the carve-out financial statements for its clothing operations applying paragraph D16(a).

X has previously prepared and issued consolidated financial statements in accordance with IFRS, which include the clothing operations. The clothing division in Jurisdiction J was acquired in 2014. From the purchase price allocation of this acquisition, goodwill is recognised in X's consolidated financial statements.

The carve-out financial statements for the year ended 31 December 2016, with 2015 comparative information, are based on the same carrying amounts as the IFRS consolidated financial statements of X, excluding the effects of consolidation procedures and the goodwill that arose as part of the business combination in which X acquired the clothing division.

The carve-out financial statements include all of the presentation and disclosures required by IFRS 1, except that no reconciliation to previous GAAP is presented (see 3.1.20).

The guidance included in *Insights into IFRS* Chapter 6.1 is applicable.



If the larger reporting entity did not issue IFRS-compliant financial statements, then paragraph D16(a) of IFRS 1 is not available. However, we have observed in practice that management might use the following approach to prepare combined and/or carve-out financial statements.

In the initial step, the larger reporting entity prepares consolidated financial statements that comply with IFRS applying IFRS 1 without issuing the prepared financial statements (i.e. the larger reporting entity does not become an IFRS adopter). In the second step, management extracts the information from the consolidated financial statements to prepare the combined and/or carve-out financial statements. In this second step, management therefore essentially applies paragraph D16(a) to the internally produced IFRS financial statements.

This approach is inconsistent with the application of paragraph D16(a) for the purposes of generic financial statements.

Financial statements prepared applying paragraph D16(b) of IFRS 1

The second possibility is to prepare combined and/or carve-out financial statements in accordance with IFRS 1 by building them up based on the entity's own date of transition. This approach follows paragraph D16(b) of IFRS 1, if the larger reporting entity has already issued IFRS-compliant financial statements. Under this approach, management applies the requirements of IFRS 1, including the mandatory exceptions, and may apply the optional exemptions provided by IFRS 1. This approach requires the combined/carved-out reporting

IFRS 1.D16(b)

entity to determine its IFRS 1-compliant amounts for the financial statements without considering the carrying amount of the larger reporting entity's assets and liabilities (see Disclosure 5G in Section 5).

 **Example 3F – Financial statements prepared applying paragraph D16(b) of IFRS 1**

In Example 3D, Group Z concluded that it would prepare the combined financial statements applying paragraph D16(b).

None of the companies in Z has previously prepared its financial statements in accordance with IFRS; instead, they have all applied local GAAP.

To prepare the combined financial statements, Z follows these steps.

<p>Step 1</p>	<p>Each of Subsidiaries S1, S2 and S3 prepares IFRS financial information that complies with IFRS for the year ended 31 December 2016, with a date of transition of 1 January 2015.</p> <p>This step is necessary in order to create the base data for the preparation of combined financial statements that comply with IFRS.¹</p>
<p>Step 2</p>	<p>The combined financial statements for the year ended 31 December 2016, with 2015 comparative information, are created by combining the IFRS financial information prepared in respect of S1, S2 and S3.</p> <p>For simplicity, this example assumes that S1, S2 and S3 have consistent accounting policies. However, if this were not the case then they would have to be aligned in preparing the combined financial statements.</p>

The combined financial statements include all of the presentation and disclosures required by IFRS 1, except that no reconciliation to previous GAAP is presented (see 3.1.20).

The guidance included in Chapter 6.1 of *Insights into IFRS* is applicable.

Note

1. Step 1 does not, in itself, make any of S1, S2 or S3 a first-time adopter of IFRS. To be a first-time adopter, a complete set of financial statements would need to be prepared, they would need to include an explicit and unreserved statement of compliance with IFRS and they would need to be distributed to external parties (see 3.1.20).

3.2.20



Combined/carved-out reporting entity is not a first-time adopter of IFRS

In our experience, there are two overall approaches that are most common for a combined/carved-out reporting entity that is not considered a first-time adopter of IFRS. Under the first approach, the financial information is extracted from the larger reporting entity (top-down approach), whereas under the second approach the financial information is based on the components of the combined/carved-out reporting entity (bottom-up approach).

Financial information is extracted from the larger reporting entity (top-down approach)

Under the top-down approach, financial information is extracted from the larger reporting entity's consolidated financial statements in order to prepare the combined and/or carve out financial statements. The assets and liabilities are extracted from the larger reporting entity and the combined/carved-out reporting entity continues to apply the same accounting policies.

Under this approach, the information in the combined and/or carve-out financial statements is considered a part of the IFRS financial statements for the larger reporting entity because financial information about the economic activities that are included in the combined/carved-out reporting entity is already reflected in the (consolidated) financial statements of the larger reporting entity. Therefore, the financial information can be extracted from the (consolidated) financial statements of the larger reporting entity.

We have observed that when applying the top-down approach without applying IFRS 1, companies *include* fair value adjustments and goodwill in the combined and/or carve-out financial statements – i.e. they extract all assets and liabilities that are allocated to the combined/carved-out reporting entity. This approach may not comply with IFRS for generic financial statements.³

The top-down approach may seem similar to the approach described in 3.2.10 (i.e. preparation using paragraph D16(a) of IFRS 1). However, we have observed that there are some differences, mainly because the reliefs provided in IFRS 1 are not applied under this approach. IFRS 1 includes numerous mandatory exceptions and optional exemptions (see respectively 6.1.230 and 240 in *Insights into IFRS*). For example, it provides an optional exemption whereby the cumulative foreign exchange differences are deemed to be zero at the date of transition (for more guidance, see 6.1.1220.10 in *Insights into IFRS*).

Financial statements prepared as if IFRS had always been applied (bottom-up approach)

When applying a bottom-up approach, management prepares the financial information of the combined/carved-out reporting entity as if the underlying components had always prepared financial statements in accordance with IFRS – i.e. IFRS is applied retrospectively and the specific reliefs in IFRS 1 are not used. In our experience, this (less common) approach is impracticable unless the components of the combined/carved-out reporting entity have a relatively short and simple history or the combined/carved-out reporting entity consists solely of whole legal entities that have prepared separate IFRS-compliant financial statements.

3.3

Disclosure of accounting policies

The choice of the overall approach to preparing combined and/or carve-out financial statements will generally depend on the intended users of the financial information and the purpose of the reporting.

The approach chosen should be clearly disclosed in the accounting policies, to enable users to understand how the combined and/or carve-out financial statements have been prepared and what the financial information contains. Further detailed disclosure of the accounting policies provides transparency to

3. See 2.6.1150 and 5.13.50–60 in *Insights into IFRS*.

users of the combined and/or carve-out financial statements and improves their relevance and usefulness.

See Section 5, in particular Chapter 5.3, for examples of disclosures on accounting policies.

3.4

Continuity of financial information

A further factor in determining the best way to prepare or present the combined and/or carve-out financial statements is the continuity of financial information for investors. For example, following a successful IPO, how will the financial information provided to shareholders connect with the financial information that was used to prepare the combined and/or carve-out financial statements?

The answer to this question sometimes depends on the requirements of the regulator in a specific jurisdiction and/or the needs of users of the financial statements. In jurisdictions where the regulator does not have specific requirements, the requirements for the presentation of subsequent financial statements (e.g. of a Newco) might influence management's decision about the approach to follow in preparing the combined and/or carve-out financial statements.



Example 3G – Continuity of financial information

Group Q has operations in several jurisdictions, in the beer and soft drink markets. Q has previously prepared consolidated financial statements in accordance with IFRS.

Q wishes to carve out and sell its soft drink division in an IPO (Newco will be the listing vehicle), and is required by regulation to prepare carve-out financial statements for the soft drink operations. This involves combining both whole subsidiaries (Subsidiaries S1 and S2) and a portion of another subsidiary (Subsidiary S3). Management has decided to use the bottom-up approach.

The carve-out financial statements will cover the year ended 31 December 2016, with 2015 comparatives. The first financial statements of Newco will cover the year ended 31 December 2017, with 2016 comparatives. The financial information will be prepared as follows.

Reporting entity	Reporting periods covered	Basis of preparation
Carved-out S1, S2 and portion of S3	1 January 2015 – 31 December 2016	Book values in the underlying financial statements of S1 – S3
Newco (consolidated financial statements)	1 January 2016 – 31 December 2017	Book values in the underlying financial statements of S1 – S3 ¹

The following diagram illustrates how these choices lead to continuity in the financial information presented to prospective investors (pre-IPO) and shareholders (post-IPO).



Note

1. Newco is formed on 1 January 2016. At this date, Subsidiaries S1, S2 and a portion of S3 are transferred to Newco. Its consolidated financial statements are prepared following the guidance in 5.13.200 of *Insights into IFRS*. In particular, management uses book value accounting and presents comparative information (see 5.13.200.120–130). Although this type of transaction generally assumes that the pre-existing business is continued, Newco might be a first-time adopter in respect of those businesses and, consequently, IFRS 1 can be applied.

Example 3G presents the ideal case, in which it is possible to present continuous financial information. However, in other cases this will not be possible because of a disconnect between the approach taken in the combined and/or carve-out financial statements and the accounting for any Newco going forward.

For example, sometimes the formation of a Newco is conditional on a successful IPO, and the new shareholders who subscribed for newly issued shares by Newco in the IPO, as a group, control Newco. In this situation, some regulators require Newco, as the vehicle for the new shareholders, to be identified as the acquirer in a business combination; this means that Newco applies acquisition accounting in accordance with IFRS 3. For a discussion of the accounting for a Newco formation in a conditional IPO, see 5.13.205 in *Insights into IFRS*.

In such cases, a type of presentation often referred to as the 'black-line approach' is sometimes used. Under this approach, a vertical line is inserted into the pages of the financial statements for the year following completion of the IPO transaction to distinguish the period before the acquisition accounting (referred to as 'predecessor') from that of the period after the acquisition accounting (referred to as 'successor'), to highlight the lack of comparability of the financial information between these two periods.

Although IFRS does not address these presentation issues, some regulators in certain jurisdictions have specific guidance on so-called predecessor/successor reporting and presentation. We recommend researching practice in your jurisdiction if you plan to apply the black-line approach in the combined and/or carve-out financial statements.





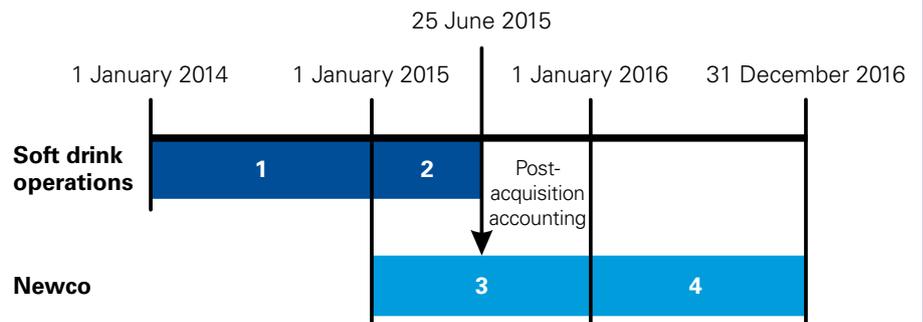
Example 3H – Black-line approach

Modifying Example 3G, the carved-out reporting entity, which includes the soft drink operations, will be transferred to a Newco.

Newco is created on 1 January 2015. The operations of the carved-out reporting entity are transferred to Newco on 25 June 2015. The IPO prospectus is filed on 10 March 2017.

The regulator requires the following in respect of Newco’s financial statements for the period ending 31 December 2016:

- Newco needs to apply IFRS 3 on acquisition of the soft drink operations; and
- Newco’s financial statements need to include three years of audited financial statements: 2014, 2015 and 2016 – i.e. the financial statements will include the carve-out financial statements of the soft drink operations as ‘predecessor’ and Newco as ‘successor’.



Considering that the regulator requires the presentation of financial statements for the period when Newco has not yet acquired the carved-out business, presenting zero operations for the period from 1 January 2015 to 25 June 2015 may not be meaningful. Given that the soft drink operations existed before the IPO, it may be more useful to include financial information for the carved-out soft drink operations in the comparative period.

Under the black-line approach, the following information is included in the combined and/or carve-out financial statements, with a black line included between the financial information of the predecessor and successor, to highlight the different accounting bases (i.e. step-up through fair value adjustment) before and after the transfer of the soft drink operations.



FY 2014	Approx 6 months of FY 2015	FY 2015	FY 2016
1 January 2014 to 31 December 2014	1 January 2015 to 25 June 2015	1 January 2015 to 31 December 2015	1 January 2016 to 31 December 2016
1	2	3	4
Soft drink operations	Soft drink operations	Newco (including post-acquisition accounting)	Newco (including the soft drink operations)

We have observed in cases similar to the example that the 2015 financial information of the soft drink operations and Newco are sometimes added together (i.e. time periods 2 and 3 are combined) to provide comparable financial information to financial year 2016 (i.e. time period 4). It is, however, noted that the financial information included in periods 2 and 3 reflects different accounting bases. Adding these periods together would not be consistent with the principles of IFRS for generic financial statements.

We are aware that some regulators in certain jurisdictions have specific guidance on so-called predecessor/successor reporting and presentation. We recommend that you research common practice in your jurisdiction if you plan to apply the black-line approach in the combined and/or carve-out financial statements.

4 Accounting policies and estimates

IAS 1.15

An entity stating that a set of financial statements complies with IFRS has to comply with all relevant standards and interpretations. The overriding requirement of IFRS is for the financial statements to give a fair presentation. To achieve this, the combined and/or carve-out financial statements need to give a faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework*.

These general principles apply to a set of combined and/or carve-out financial statements in the same way as to any other set of financial statements prepared in accordance with IFRS. Therefore, certain features of these financial statements often mean that considerable judgement is required in their preparation. The main areas that require judgement are outlined in this section.

This section does not repeat the requirements of IFRS or the interpretative guidance included in *Insights into IFRS*, although in a number of cases cross-references are included.

4.1 Implications of a separate combined/carved-out reporting entity

The combined/carved-out reporting entity is a different reporting entity from the larger reporting entity (if applicable), and therefore a number of specific issues need to be considered. This is similar to the preparation of a set of separate financial statements for a parent or subsidiary as a stand-alone entity when it previously prepared only consolidated financial statements or the preparation of a set of consolidated financial statements of a sub-group of a larger reporting entity.

4.1.10 Accounting policies

Because the combined and/or carve-out financial statements relate to a different reporting entity from those of the larger reporting entity, the accounting policies adopted by the combined/carved-out reporting entity do not have to be the same as those of the larger reporting entity. For example, the combined/carved-out reporting entity might decide to revalue land and buildings in accordance with the revaluation model in IAS 16 *Property, Plant and Equipment*, whereas the larger reporting entity accounted for them on a cost basis.

However, if the combined and/or carve-out financial statements use the top-down approach (see Section 3) and the financial information is extracted from the larger reporting entity, then it is likely that the extracted accounting policies applied by the combined/carved-out reporting entity remain unchanged. If management, however, decides to modify the extracted accounting policies, then additional disclosures are considered critical to the users' understanding and their information needs (see Chapter 3.3).

4.1.20

Perspective of the combined/carved-out reporting entity

The accounting for transactions and events should reflect the perspective of the combined/carved-out reporting entity to achieve a fair presentation. This is the same concept as separate financial statements reflecting the perspective of the stand-alone entity and not the perspective of the group.

The following are examples of potential changes in accounting treatment.

- If there is an arrangement between the larger reporting entity and the combined/carved-out reporting entity that is a lease in accordance with IAS 17 *Leases*, then this relationship is accounted for as such in the combined and/or carve-out financial statements. For guidance on the identification and classification of leases, and the related accounting, see Chapter 5.1 in *Insights into IFRS*. This includes guidance on when an arrangement is not in the form of a lease but is nonetheless accounted for as a lease (see 5.1.510 in *Insights into IFRS*).
- Property that was accounted for as property, plant and equipment by the larger reporting entity might be investment property for the combined and/or carve-out financial statements. Therefore, it would be accounted for as investment property in the combined and/or carve-out financial statements. For guidance on the classification of and accounting for investment property, see Chapter 3.4 in *Insights into IFRS*.
- Depending on the level of integration between the components of the combined/carved-out reporting entity and the larger reporting entity, the combined and/or carve-out financial statements might include a significant level of inter-company transactions between the two reporting entities. Transactions that were previously eliminated in the larger reporting entity would need to be reinstated, and would need to be factored into the disclosures made under IAS 24 *Related Party Transactions*.

4.2

Accounting treatment for related party transactions in combined and/or carve-out financial statements

The users of a set of combined and/or carve-out financial statements are very often prospective investors – e.g. when an IPO is planned for part of a group's operations. In this case, they have a particular interest in understanding the historical results of the combined/carved-out reporting entity from a stand-alone point of view (without becoming pro forma). As a consequence, there is often a focus on whether the treatment of related party transactions is appropriate for the combined and/or carve-out financial statements.

The following are examples of typical related party transactions in combined and/or carve-out financial statements.

- Transfer of goods and/or services between the larger reporting entity and combined/carved-out reporting entity (e.g. intragroup sales transaction).
- Transfer of businesses, including contributions and distributions of businesses.
- Common costs incurred by either the larger reporting entity or the combined/carved-out reporting entity – e.g. overheads and general and administrative expenses.

- Shared assets or liabilities held by either the larger reporting entity or the combined/carved-out reporting entity but used by the other – e.g. an overarching financing structure.

Such transactions are related party transactions regardless of whether a price is charged.

4.2.10

Measurement and/or allocation of related party transactions

There may be transactions between the larger reporting entity and components of the combined/carved-out reporting entity, including any transfer of resources (e.g. use of assets), services (e.g. head office services) or obligations. The amount charged for the goods or services may be at fair value at the date of the transaction. However, the price may be determined based on an inter-company formula that is not equal to an arm's length basis.

From the perspective of the combined and/or carve-out financial statements, these transactions are related party transactions. Although they do not affect the (consolidated) financial statements of the larger reporting entity, because any amounts received or paid in respect of a transaction are eliminated in the course of consolidation (see Chapter 4.4), they will be reflected in the combined and/or carve-out financial statements.

Insights 5.5.20.10

IAS 24 does not establish any recognition or measurement requirements for related party transactions; the amount recognised is generally the amount charged.

Therefore, when preparing combined and/or carve-out financial statements, it will be necessary to determine an appropriate approach to recognise transactions between the combined/carved-out reporting entity and the larger reporting entity.

Related party transactions charged on an arm's length basis

If there are no significant related party transactions, or all such transactions are charged on an arm's length basis, then the combined/carved-out reporting entity will apply the recognition and measurement requirements of the relevant standards to the amount charged. This approach is consistent with the principles of IFRS for generic financial statements.

Related party transactions not measured and/or allocated on an arm's length basis

Insights 5.5.20

If related party transactions between the larger reporting entity and the combined/carved-out reporting entity are *not* measured and/or allocated on an arm's length basis, then in our experience an entity chooses one of two approaches to prepare its combined and/or carve-out financial statements:

- *Approach 1:* applying the relevant standard or, where a transaction with shareholders is identified, the transaction might be measured at fair value; or
- *Approach 2:* allocating the actual costs incurred by the larger reporting entity on a rational basis to the combined/carved-out reporting entity, regardless of whether an amount is charged or whether the actual costs reflect fair value.



The two approaches are discussed in more detail below. We acknowledge that both approaches may be appropriate for combined and/or carve-out financial statements, depending on the facts and circumstances of the particular situation. For example, in some jurisdictions regulators require the combined and/or carve-out financial statements to include all attributable costs of doing business, which might involve applying the second approach. We recommend researching common practice in your jurisdiction before selecting an approach.

Applying the relevant standard or, where a transaction with shareholders is identified, the transaction might be measured at fair value

This approach may be applied if the amount charged between the combined/ carved-out reporting entity and the larger reporting entity is *not* on an arm's length basis.

Under this approach, management assesses the economic substance of the transaction and whether there is specific guidance in IFRS on the recognition and measurement of the transaction. When assessing the economic substance of the transaction, management considers whether there is an element of the larger reporting entity acting as a shareholder in the transaction price. Management needs to assess whether in substance a distribution or contribution between the two entities has occurred. If it is a related party transaction, then it may be measured at fair value in the combined and/or carve-out financial statements. In practice, certain jurisdictions require transactions with shareholders to be recorded at fair value, depending on specific facts and circumstances.

Additionally, management assesses whether there is specific guidance that applies to the transaction, in which case the standard is applied to the transaction for the preparation of the combined and/or carve-out financial statement.

For example, revenue is measured in accordance with IAS 18 *Revenue* or IFRS 15 *Revenue from Contracts with Customers* and loans are measured in accordance with IAS 39. In addition, some standards may require the attribution of costs – e.g. under IFRS 2 *Share-based Payment* in respect of equity instruments granted by the parent directly to the employees of a subsidiary.

However, in the absence of specific requirements, for the purposes of the combined and/or carve-out financial statements management needs to consider the accounting for related party transactions carefully, having regard to all facts and circumstances, and take into account their substance as well as their legal form.

This approach results in the requirements of the relevant standards (e.g. IAS 17) being applied to the arm's length value (i.e. fair value) of the transaction, rather than the transaction price, and the difference between the transaction price and the fair value of the transaction being considered a capital contribution or distribution.

Example 4A illustrates its application in practice.

Insights 1.2.80

**Example 4A – Applying the relevant standard or, where transactions with shareholders are identified, the transaction might be measured at fair value**

Parent P is preparing a set of carve-out financial statements for certain operations that will be disposed of in an IPO. Company S, a subsidiary of P, is one of the components in the carve-out financial statements.

Scenario 1: Related party transaction for no consideration

S gives inventory to P without consideration. In this scenario, it can be argued that P has received a benefit from S in its capacity as a shareholder because an independent third party would not have been given the inventory for free.

Management needs to consider the materiality of the transaction and the objectives of the carve-out financial statements to determine the specific requirements in the standards applicable to the specific transaction.

In this scenario, we have observed in practice that the transaction may be treated as a distribution to the parent, with the difference between the transaction price (i.e. zero in this scenario) and the fair value of the inventory transferred being recognised in equity of the combined/carved-out reporting entity.

Scenario 2: Related party transaction at above-market rates

S sells inventory to P at a price that is well in excess of fair value. Again, management needs to consider the materiality of the transaction and the objectives of the carve-out financial statements to determine whether there are any specific requirements for the measurement of this specific transaction in IFRS.

In practice, we have observed that the transaction in this scenario may be split into two parts:

- a sale of goods is recognised at fair value in profit or loss; and
- the excess proceeds are recognised directly in equity as a capital contribution.

Measuring and/or allocating the actual costs incurred by the larger reporting entity on a rational basis to the combined/carved-out reporting entity, regardless of whether an amount is charged or whether the actual costs reflect fair value

This approach is observed in practice when the amount charged between the combined/carved-out reporting entity and the larger reporting entity is *not* on an arm's length basis.

Under the second approach, the measurement and/or allocation of related party transactions in combined and/or carve-out financial statements is on a rational basis, regardless of whether an amount is charged or whether the actual costs reflect fair value.

The measurement and/or allocation need to be based on a systematic, consistent and rational basis appropriate for each item being allocated and/or measured. Measurements and/or allocations by size (e.g. total revenue or total assets) are likely to be inappropriate unless a direct correlation can be drawn between size and the expense incurred. Examples of reasonable bases for determining measurement and/or allocations include specific identification, headcount, usage, payroll, square footage and time spent. The determination of the most appropriate measurement and/or allocation metric may vary by industry.

Measurements and/or allocations should also be reasonable in the context of the larger reporting entity. For example, if the same allocation method was applied to the entire entity and would result in more than the actual total expense incurred being allocated, then the measurement and/or allocation method would appear to be unreasonable. In some cases, it might be more appropriate to measure and/or allocate the item on the basis of a fair value approach, rather than as an apportionment of the amount recognised in the (consolidated) financial statements of the larger reporting entity.



However, awareness is required when this approach is followed. In our experience, legal entities at the top of a group often incur costs for provided central services. If this item is apportioned to the combined and/or carve-out financial statements on a basis different from the basis used to determine the actual head office charge incurred, then an adjustment should be made for the charge to avoid double counting.

This approach has technical merit solely for the purposes of combined and/or carve-out financial statements and is not consistent with the principles of IFRS for generic financial statements.



Example 4B – Measuring and/or allocating the actual costs incurred by the larger reporting entity on a rational basis to the combined/carved-out reporting entity

Parent P is preparing a set of carve-out financial statements for certain operations that will be disposed of in an IPO. P provides two centralised services to all subsidiaries for no charge.

- *HR services*: These services are provided across the group on a standardised basis and an apportionment of the cost incurred centrally by P would be representative of the likely cost that the combined/carved-out reporting entity would have incurred had it been a stand-alone business.
- *IT services*: These services are specialised and key to the business strategy of the carved-out reporting entity. An apportionment of the cost incurred centrally by P would *not* be representative of the likely cost that the combined/carved-out reporting entity would have incurred had it been a stand-alone business.

Although the purpose of the carve-out financial statements is not to present the entity as if it had been a stand-alone business (see Chapter 4.1), management concludes that measuring and/or allocating the IT services provided by P on a rational basis – e.g. the actual usage of the IT services based on technical metrics – will result in more meaningful information. The HR services are measured based on an apportionment of the cost incurred by P allocated based on the headcount of the carved-out reporting entity.

Disclosure

IAS 24.3–4

Regardless of the chosen approach, the disclosure requirements for related party transactions apply to all components included in the combined/carved-out reporting entity. Transactions within the combined/carved-out reporting entity are eliminated in the combined and/or carve-out financial statements (see Chapter 4.4 for guidance about the consolidation procedures); however, transactions between the combined/carved out reporting entity and the larger reporting entity need to be disclosed.

In our experience, additional disclosure may be required based on local rules and regulations. Nonetheless, those specific legal requirements may supplement the disclosure of related party transactions in the combined and/or carve-out financial statements but cannot override any requirement to provide appropriate disclosure under IFRS (see Disclosure 5J in Section 5 for an example).

4.2.20

Qualitative considerations

Although all of the approaches outlined in Chapter 4.2 are acceptable for combined and/or carve-out financial statements, depending on the specific facts and circumstances and practice in the jurisdiction, the treatment (i.e. measurement and/or allocation) of related party transactions should not be arbitrary and should be based on transactions that actually happened and are clearly identifiable (see Chapter 1.1). The objective of all measurements and/or allocations, if there are any, is to give a fair presentation of the combined/carved-out reporting entity in its financial statements.

It is equally important to ensure that the measurements and/or allocations are reliable and verifiable without distorting the intended purpose of the combined and/or carve-out financial statements. For example, a carve-out of a division in which assets and personnel are shared with other components outside the combined/carved-out reporting entity may require more complex measurements and/or allocations than are needed for a component that is a separate legal entity, maintains separate accounting records and has separate assets and personnel. As the complexity in the computation of measurements and/or allocations increases, so may the level of judgement required to assess whether the resulting financial statements are consistent with their intended use.

4.3

Estimates and compliance with IFRS

Estimation is an essential part of the preparation of any set of financial statements. However, the extent of estimates in preparing combined and/or carve-out financial statements can be a key factor in determining whether compliance with IFRS can be achieved.

In determining whether it is practicable for management to prepare combined and/or carve-out financial statements that comply with IFRS, management assesses the extent to which the entity is able to separate each component's financial performance and assets/liabilities from those of the larger reporting entity (if one exists). Factors to consider in making this determination include the following.

Factor	Consideration
Legal structure of the combined group	Stand-alone legal entities generally require less extensive measurements and/or allocations than components of legal entities.
Nature of businesses being combined/ carved out	The more dissimilar the businesses to be included or excluded, generally the fewer the allocations.
Management of the business	Components that have historically been managed separately and have separate accounting records and systems generally require fewer measurements and/or allocations than components managed together, and/or with common accounting records and systems.
Extent of common assets, liabilities, revenues and costs	The fewer the common assets, liabilities, revenues, costs and personnel, the fewer the allocations and/or measurement necessary.

Example 4C is an illustration of a pervasive treatment of estimates.

 **Example 4C – Pervasive treatment of estimates**

The government in Country Y is planning to privatise its national telecoms services, which are fully integrated services comprising all aspects of telecoms infrastructure and the delivery of services to customers. The government has previously prepared financial statements for the business, but there has been no operational separation between the two parts of the business described below.

Following privatisation, there will be two separate groups.

- Telecoms utility business, which will own and operate the national fixed-line access network infrastructure.
- Telecoms and IT services provider, comprising fixed, mobile and software businesses.

As part of the demerger, management is required to prepare two separate sets of carve-out financial statements.

```

    graph TD
      Government[Government] --> Telecoms[Telecoms assets and services fully integrated]
      Telecoms --> Utility[Telecoms utility business]
      Telecoms --> IT[Telecoms and IT services provider]
  
```

In deciding whether the carve-out financial statements can comply with IFRS, management considers the following.

Legal structure of the combined group	The parts of the telecoms business are a single integrated business unit. Different parts of the business are not in separate legal entities.
Nature of businesses being combined/ carved out	The businesses are integrally related, representing two parts of a complete telecoms service.
Management of the business	Historically, the components have been managed together, with a single set of accounting records and the same accounting systems.
Extent of common assets, liabilities, revenues and costs	Although the assets are now being separated, they were previously used to provide a fully integrated service for customers, and revenues and costs were not separated.

After considering all of these factors, management concludes that the measurements and/or allocations needed in preparing the carve-out financial statements will be extensive, and as a result the financial statements will not comply with IFRS.

Instead, management intends to prepare special-purpose carve-out financial statements, in which the recognition and measurement principles of IFRS will be applied to the separately identifiable assets and liabilities of the respective operations.

Awareness is required

Chapters 4.2 and 4.3 highlight the different accounting practices for related-party transactions and estimates that have been observed in practice. We emphasise that the accounting treatment of related party transactions is an area in which consultation with your KPMG professional is recommended to understand the predominant practice in your jurisdiction.



4.4

IFRS 10.B86–B99

Consolidation procedures

In preparing combined and/or carve-out financial statements, the usual consolidation procedures in IFRS 10 apply. This includes uniform accounting policies, intragroup eliminations that occurred within the combined/carved-out reporting entity and the accounting for non-controlling interests.

There might be transactions between a component of the combined/carved-out reporting entity and a component of the larger reporting entity that were previously eliminated on consolidation. These transactions are reinstated in the combined and/or carve-out financial statements. For upstream sales from the combined/carved-out reporting entity to the larger reporting entity, this means that the revenue/cost of goods sold is recognised. For downstream sales from the larger reporting entity to the combined/carved-out reporting entity, the inventory and a payable are recognised.

Conversely, there might be transactions between two components of the combined/carved-out reporting entity that were not previously eliminated because the components were not part of the same set of consolidated financial statements – e.g. they were part of sister groups. These transactions are eliminated in preparing the combined and/or carve-out financial statements.

4.5

4.5.10

Statement of financial position

Shared assets

All property, plant and equipment that is clearly attributable to the combined/carved-out reporting entity (i.e. not shared assets) is recognised in the financial statements. Its carrying amount is determined consistently with the approach taken in preparing the combined and/or carve-out financial statements (see Section 3).

In many cases, at least some assets are shared between the combined/carved-out reporting entity and the larger reporting entity – e.g. land, corporate facilities, mainframe computers or common manufacturing or distribution facilities etc – for which specific identification cannot be achieved because both the combined/carved-out reporting entity and other components of the larger reporting entity use them and neither can conduct its business without them.

The accounting treatment of shared assets requires judgement on the part of management over whether the asset should be recognised in the combined and/or carve-out financial statements. If it is, then the issue remains how the shared asset should be measured and/or allocated.

Globally, we have observed the application of different accounting treatments for the measurement and/or allocation of related party transactions in combined and/or carve-out financial statements. Those treatments are described in Chapter 4.2. In this chapter, we focus on the accounting treatment for the recognition of the shared assets only.

Similar to the accounting for related party transactions, we have observed two approaches for the accounting treatment of shared assets.

The first approach observed in practice is similar to Approach 1 discussed in Chapter 4.2. Under this approach, management considers whether there is a recognition requirement in IFRS for the shared asset. Under the applicable standard, IAS 16, the combined/carved-out reporting entity might not control

the shared asset and therefore does not recognise the asset in the combined and/or carve-out financial statements. However, because the combined/carved-out reporting entity generally uses and benefits from the shared assets, other standards might be applicable – e.g. IAS 17 in combination with IFRIC 4 *Determining whether an Arrangement contains a Lease*.

It is observed in practice that the shared asset is generally treated as an operating lease. As a consequence, the combined/carved-out reporting entity (i.e. lessee) does not recognise the leased asset in its combined and/or carve-out financial statements. The combined/carved-out reporting entity, however, includes the expense associated with the use of the shared assets.

Similar considerations to those outlined in Chapter 4.2 apply to whether there is an element of the larger reporting entity acting in its capacity as a shareholder in any transactions involving shared assets and, consistent with Example 4A, in some cases it may be appropriate to recognise a capital contribution or distribution and to measure the use of the shared asset at fair value.

The second, less common, approach that we have observed is that the asset is recognised in the combined and/or carve-out financial statements, together with the related depreciation and any impairment losses. 'Allocated' income (a recovery charge) is recognised for the use of the asset by other components of the larger reporting entity, measured in accordance with one of the approaches outlined in 4.2.10.

These approaches may not be consistent with the principles of IFRS for generic financial statements. However, both approaches may have some technical merit for combined and/or carve-out financial statements.

Following principles similar to property, plant and equipment, recognisable intangible assets clearly attributable to the combined/carved-out reporting entity are usually accounted for following either of the two approaches highlighted above in the combined and/or carve-out financial statements. Most businesses have intangible assets, including licences, trademarks, patents and customer lists, which may have been developed internally or purchased, or may have been acquired in a business combination.



4.5.20

Impairment testing of non-financial assets

The preparation of combined and/or carve-out financial statements does not in itself represent a triggering event for impairment testing under IAS 36 *Impairment of Assets*. However, an indication of impairment may exist because the identification and aggregation of cash-generating units and the measurement and/or allocation of 'reorganised' goodwill (see Section 3) in the combined and/or carve-out financial statements differs from the application of IAS 36 in the larger reporting entity's consolidated financial statements. This means that additional impairment testing might be required for the purposes of the combined and/or carve-out financial statements.

For further guidance, see Chapter 3.10 in *Insights into IFRS*.

In addition, to the extent that IFRS 1 is applied and the combined/carved-out reporting entity uses the optional exemption for business combinations, goodwill acquired in an *unrestated* business combination is required to be tested for impairment at the date of transition, and we prefer that goodwill acquired in a *restated* business combination is tested for impairment at the date of transition.

Insights 6.1.1060.50, 1110

4.5.30

Financing

One of the most difficult areas in preparing combined and/or carve-out financial statements can be the presentation of debt (and equity). If the financial statements are being prepared for an IPO or other transaction in which control over the combined/carved-out reporting entity will change, then the key information for users of those financial statements is often how the post-transaction entity will be financed.

However, preparing the combined and/or carve-out financial statements on the basis of the future planned financing structure may be a pro forma presentation (see Section 1), rather than historical financial information; in that case, the combined and/or carve-out financial statements cannot be prepared on that basis. Instead, the notes to the financial statements (and pro forma financial information outside the financial statements) would generally include disclosures about the planned financing. For example, future third party financing and/or future debt issuance would not be anticipated in the historical financial statements, but disclosed in the notes to those financial statements.

So although it is clear that the combined and/or carve-out financial statements need to represent the historical financing of the combined/carved-out reporting entity, this can give rise to a number of complications, especially when some or all components of the combined/carved-out reporting entity were not separate legal entities. This chapter discusses some of the issues that are common in our experience, and how the financial instruments standard (IAS 39) should be applied in the combined and/or carve-out financial statements.

IAS 39.14

Because there is specific guidance in IAS 39 – supported by our interpretative guidance in *Insights into IFRS* – this may take precedence in recognising and measuring financing transactions, depending on which approach is followed for related party transactions (see 4.2.10).

Related party loans at off-market rates

IFRS 13.47, IAS 1.69

Complications often arise in preparing combined and/or carve-out financial statements because loans between components of the larger reporting entity (inter-company loans) may have off-market terms, but this was not previously relevant because the loans were eliminated on consolidation at the larger reporting entity level. Therefore, these terms may become relevant for the first time when the combined and/or carve-out financial statements are being prepared.

IAS 39.AG64, 32.15

A key issue is to determine whether a loan is equity or a liability. If the borrower has no obligation to repay a loan received or to make interest payments, then the loan is classified as equity and any payments made to the lender are recognised as distributions to owners. If the borrower has a contractual obligation to repay the loan, then the obligation is classified as a financial liability and returns to the owner are usually recognised as interest expense. Financial liabilities are initially recognised at fair value less transaction costs for liabilities not at fair value through profit or loss in accordance with IFRS 13 *Fair Value Measurement*. This may be less than the amount advanced if an inter-company loan has a below-market rate of interest or is interest-free from the perspective of the combined/carved-out reporting entity. If so, this initial discount is generally treated as a capital contribution and the interest expense recognised on the loan is increased above the contractual rate.

Insights 7.6.100.30–40

The analysis may be more complicated if there are no stated terms of repayment and it is not clear when repayments will take place, what their value will be and what the term of the loan is. For generic financial statements the guidance and interpretations included in *Insights into IFRS* are applicable. *Insights into IFRS* states that, in these cases, in our view consideration should first be given to whether:

- classification as a liability is appropriate;
- there is no agreed means of repayment, either directly in the agreement or via a side agreement; and
- it is possible to estimate when the loan repayments will take place.

Insights 7.6.70.30

Similar to the above, in the case of generic financial statements, *Insights into IFRS* states that in our view, having considered these factors and concluded that no alternative treatment is available, such a loan may be considered to be payable on demand. In this case, the loan is measured at its face value and classified as a current liability (to the extent that a classified statement of financial position is presented) in the combined and/or carve-out financial statements. For further guidance on the accounting implications of low-interest and interest-free loans, see 7.6.100 in *Insights into IFRS*.



We have observed in some jurisdictions that related party loans are not always initially measured at fair value less transaction costs as described in the above paragraphs. Although this accounting treatment would not be considered to comply with the requirements of IFRS for generic financial statements, it appears to be an accepted approach in some jurisdictions.

Allocation of financing to the combined and/or carve-out financial statements



It is presumed that third party financing agreements that are considered for allocation to the combined and/or carve-out financial statements are already in place within the larger reporting entity. This means that financing agreements created after the reporting date are not reflected in the combined and/or carve-out financial statements, because doing so would be considered pro forma information.

In practice, it has been observed that, in some cases, third party loans might be established directly through a contract with a component of the combined/carved-out reporting entity, or the loan might have been legally assigned or assumed by a component of the combined/carved-out reporting entity. In these cases, it may be straightforward to attribute the loans to the combined and/or carve-out financial statements.

If this is not the case, it has also been observed in practice that debt is allocated to the combined/carved-out reporting entity if there is only a direct (legal) link to the assets or other economic activities that are recognised in the combined and/or carve-out financial statements – e.g. through the existence of a mortgage or lien established as security for creditors.

4.5.40

Receivables and payables

Companies typically have three types of receivables or payables: trade accounts receivable/payable, inter-company receivables/payables and miscellaneous (other) receivables/payables. All receivables and payables that are specifically attributable to the combined/carved-out reporting entity should be recognised in the financial statements.

In some cases, however, accounts receivable may be accumulated and managed at the customer level by the larger reporting entity. For example, a single location may contain multiple businesses, including the business that is a part of the combined/carved-out reporting entity. That location might invoice a customer on a single invoice, regardless of the business from which the customer purchased. In this situation, management will typically be able to fully or partially reconstruct accounts receivable. However, if reconstruction is not feasible – e.g. because there are no individual/separate records of sales/services captured by each business or division, and there was no historical practice of allocating cash payments to individual businesses/divisions – then management can consider other reasonable allocation methods to determine the accounts receivable balance. Relative sales might be a reasonable allocation method because of its clear and close relationship to the accounts receivable balance.

The same reconstruction issue arises in product-line carve-outs, whereby trade receivables information might be commingled between the carve-out product and product(s) that remain with the parent. This also requires careful scrutiny to determine whether the trade receivable balances can be attributed to the combined/carved-out reporting entity or whether a reasonable allocation method is necessary. What constitutes a 'reasonable' allocation method will depend on the specific facts and circumstances.

Similar issues arise in respect of accounts payable, and it might be necessary to reconstruct the balances attributable to the combined/carved-out reporting entity. This might be done, for example, through a line-by-line review of expenses traced to the specific corresponding payable.

4.5.50

Cash and cash equivalents

Larger reporting entities often use centralised cash management functions involving sweep accounts, as well as centralised cash collection and payment centres. When customers and/or suppliers of the combined/carved-out reporting entity overlap with those of the remaining larger reporting entity, it can be difficult to identify the relevant receivables and payables (see 4.5.40).

The components of the combined/carved-out reporting entity might have participated in a centralised treasury management system without any legal right to deposit or withdraw funds autonomously. This means that no notification to and permission from the larger reporting entity is given or obtained. In this situation, funds are not generally considered cash of the combined/carved-out reporting entity and are not included in its statement of financial position. However, any stand-alone bank accounts to which the components of the combined/carved-out reporting entity have legal rights and access are recognised in its statement of financial position. The following are common cash accounts.

- *Petty cash* is usually maintained at various locations within the parent entity, and amounts related to the combined/carved-out reporting entity are in practice often considered immaterial.
- Any *restricted cash* related to the combined/carved-out reporting entity's operations and agreements is recognised in the financial statements with appropriate disclosure in the notes.

IAS 7.48

IFRS 12.13

- *Cash held in foreign operations* that are part of the combined/carved-out reporting entity might not be transferred (repatriated) to the country in which the corporate headquarters of the parent leading the centralised cash management resides, because of potential legal and tax consequences. These accounts are typically recognised in the combined and/or carve-out financial statements with appropriate disclosure in the notes.

Notwithstanding the specific arrangements for access when there is a central treasury function, cash balances related to the combined/carved-out reporting entity might be specifically included in the scope of the reporting entity. In our experience, it is common in private M&A transactions for the parties to make specific provision for cash balances – e.g. including some centralised cash balances in the combined and/or carve-out financial statements.

4.6

Statement of profit or loss and OCI

Components of profit or loss and OCI follow the guidance in the relevant standards. However, in the context of combined and/or carve-out financial statements, there may be shared income and expenses that are an allocation of the income and expenses in the larger reporting entity, and/or income or expenses that represent a transaction that was previously implicit or notional. For a general discussion of the remeasurement of transactions and for a general discussion of allocations, see Chapter 4.2.

4.6.10

Revenue

Revenue in the combined and/or carve-out financial statements reflects the complete historical sales activities of the combined/carved-out reporting entity, which may require the identification of transactions with the wider group (see Chapter 4.4).

4.6.20

Cost of goods sold

The cost of goods sold may be specifically identifiable for each revenue transaction, or may be commingled with costs incurred to support multiple transactions. When costs cannot be specifically identified, a reasonable and appropriate allocation metric is used. The metric may be based on the pattern of sales, production attributes, customer attributes, historical metrics used and analysed by the parent company, or any other reasonable approach, which will vary based on the entity's business and/or industry.

4.6.30

Interest expense

The determination, allocation and recognition of interest expense is inextricably linked to the underlying financial liabilities recognised in or attributable to the statement of financial position in the combined and/or carve-out financial statements. Accordingly, the amount of interest expense recognised is generally based on the effective interest method applied to the underlying financial liabilities that are recognised (see 4.5.30).

4.6.40

Income taxes

For guidance on how to allocate income taxes to individual entities within a tax-consolidated group, see *Insights into IFRS*. In summary, there are two basic approaches.

Insights 3.13.1160

– *Approach 1:* Current and deferred income taxes are recognised by each entity in the group, regardless of who has legal liability for settlement or recovery of the tax.

Insights 3.13.1170

– *Approach 2:* Each entity recognises current income taxes based on the amounts actually paid by the individual legal entities.

The above guidance is based on the assumption that the individual components of the financial statements are entities and the consolidated group was able to, and did, elect to be treated as a single entity for income tax purposes. However, the combined/carved-out reporting entity may include smaller components for which an allocation of income tax expense will be required. Therefore, in this case it would be necessary to allocate an appropriate share of income tax expense to components of the combined/carved-out reporting entity that are not separate taxable entities in order to reflect all expenses attributable to that entity. In our experience, a common method is to allocate income taxes as if the component were a separate taxable entity (see Disclosure 5K in Section 5).

Approach 2 may not be an appropriate method if entities or smaller components included in the combined/carved-out reporting entity did not historically make actual payments for income taxes – e.g. because the component did not file a separate tax return. In this case, showing no income taxes may not result in meaningful information for users of the combined and/or carve-out financial statements.

4.6.50

Employee benefits – Defined benefit plans

Often, the employees transferred with the businesses into the newly created combined/carved-out reporting entity have participated in the larger reporting entity's employee benefit plans. However, those plans have not in legal terms existed between the employees and the specifically identified economic activities – either in the form of separate legal entities or unincorporated businesses or partnerships – that are reflected in the combined and/or carve-out financial statements. Instead, legally (i.e. based on the contractual arrangements) the benefits to which the employees are entitled have rested with the parent entity or another legal entity controlled by the ultimate parent.

Insights 4.4.200

For guidance on how to account for group plans in the financial statements of the individual entities (components) in the group that may be useful in preparing combined and/or carve-out financial statements, see 4.4.200 in *Insights into IFRS*. Under that guidance, the accounting for defined benefit group plans in the combined and/or carve-out financial statements will depend on whether there is a contractual agreement or stated policy for charging the net defined benefit cost to individual group entities, as outlined below.

Contractual agreement or stated policy exists

IAS 19.41, 120

If a contractual agreement or stated policy exists for charging to individual group entities the IAS 19 *Employee Benefits* cost for the plan as a whole, then the entity recognises the net defined benefit cost allocated to it under the agreement or policy. The net defined benefit costs allocated to and recognised by group entities under a contractual agreement or a stated policy are measured in accordance with IAS 19 and are therefore, in aggregate, equal to the amount recognised at the group level in profit or loss and in OCI.

Insights 4.4.210.20

IFRS is silent on where the allocated net defined benefit costs should be recognised in the financial statements of group entities. In the case of generic financial statements the guidance and interpretations included in *Insights into IFRS* are applicable. *Insights into IFRS* states that, in our view, participants in a group plan should not generally recognise any of the allocated amount outside profit or loss; instead, they should recognise it as a single expense within personnel expenses. However, there may be circumstances in which recognition of a portion of the allocated amount outside profit or loss is appropriate – e.g. if there is a reasonable basis for allocating remeasurements to group entities.

This accounting is explained further in 4.4.210 in *Insights into IFRS*.

No contractual agreement or stated policy in place

IAS 19.41

In general, if there is no contractual agreement or stated policy in place, then the net defined benefit cost is recognised by the group entity that is legally the sponsoring employer for the plan. The other participants in the plan recognise in profit or loss an amount equal to their contributions payable for the period.

From the perspective of the combined/carved-out reporting entity, the accounting by the legal sponsor is relevant only when the legal sponsor is included in the combined/carved-out reporting entity. The accounting in that case is explained further in 4.4.220 in *Insights into IFRS*.

Introduction or removal of stated policy or contractual agreement

In the case of a transaction, the existing arrangements between entities within the group are often changed to accommodate the newly created combined/carved-out reporting entity. As a result, a stated policy or contractual agreement may be introduced or removed.

Insights 4.4.230.10

In the case of generic financial statements the guidance and interpretations included in *Insights into IFRS* are applicable. *Insights into IFRS* states that if the plan remains a defined benefit plan, then in our view the general principles of changes in the classification of a multi-employer defined benefit pension plan should be applied to the respective recognition and derecognition of a share in an existing deficit or surplus – i.e. the resulting change in estimate should be accounted for under whichever of defined contribution or defined benefit accounting principles is to be applied after the event causing the change in classification.

Accordingly, if the plan has a deficit and a policy or agreement is removed or introduced, then the following accounting alternatives may be relevant for the combined and/or carve-out financial statements.

- If a policy or agreement is removed by the parent, then the combined/carved-out reporting entity would derecognise its portion of the deficit and recognise the gain resulting from that change in estimate in profit or loss.

- If a policy or agreement is introduced by the parent, then the combined/carved-out reporting entity would recognise a remeasurement loss equal to the newly recognised share of net defined benefit liability.

This accounting is explained in 4.4.230 in *Insights into IFRS*.

Any such change should not be anticipated in the combined and/or carve-out financial statements before it actually happens; any anticipation of the event would be a pro forma adjustment (see Section 1).

4.6.60

Share-based payments

IFRS 2 includes specific guidance on accounting for group share-based payments that will apply equally to the components of the combined and/or carve-out financial statements (see 4.5.1440 in *Insights into IFRS*).

Under this guidance, the financial statements will include all share-based payment-related costs attributable to employees of the combined/carved-out reporting entity. The expenses to be recognised might be specifically identifiable or, if they are tracked on an aggregated level – e.g. by division or factory plant – determined and allocated on a reasonable basis.

4.6.70

IAS 19, IFRS 2

Bonus payments

In conjunction with a public offering, it is common for bonuses to be awarded based on the successful completion of the offering. For example, Parent P is planning to spin off certain operations and is preparing carve-out financial statements for the spin-off vehicle (i.e. Newco). If the spin-off of Newco is successful, then management will receive a bonus.

In this situation, management first needs to determine whether these costs are directly attributable to the combined/carved-out reporting entity. This is typically determined by analysing the roles of the employees and whether they will be retained by the combined/carved-out reporting entity.

Having determined that the bonus should be recognised in the combined and/or carve-out financial statements, the accounting depends on whether the bonus is an employee benefit in the scope of IAS 19 or a share-based payment in the scope of IFRS 2.

For bonuses in the scope of IAS 19, the accounting is based on whether the entity has a present legal or constructive obligation and a reliable estimate of the obligation can be made (see 4.4.1270 in *Insights into IFRS*).

For bonuses in the scope of IFRS 2, see 4.5.460 in *Insights into IFRS*. For example, the IPO may be deemed a non-vesting condition or a non-market performance condition within a share-based payment plan, depending on the timing of the successful IPO transaction relative to the service period and when the employee becomes entitled to the award.

4.7

Equity

In the context of combined and/or carve-out financial statements, the traditional captions in equity (share capital, share premium, retained earnings etc) are often not relevant. Therefore, it is common for the equity section of the statement of financial position to be a single line item, often called 'net parent investment'. This will be the corresponding entry in equity for the measurements discussed in Chapter 4.2.

SEC FRM 7410

In conjunction with an SEC filing, retained earnings should not be reported separately by a non-corporate entity. The residual interest should be presented as a single component called, for example, 'parent's equity in division'.

4.8

Other allocation and presentation issues

4.8.10

Assets held for sale and discontinued operations

For combined and/or carve-out financial statements prepared as part of a transaction such as an IPO, the financial statements might include assets and/or operations that are held for sale or discontinued. Depending on whether the assets and/or operations will be included in Newco, their classification may be different in the combined and/or carve-out financial statements compared with the consolidated financial statements of the larger reporting entity. For example, certain components of the combined/carved-out reporting entity were classified as held-for-sale/discontinued operations in the consolidated financial statements of the larger reporting entity, but that classification is reversed when the combined and/or carve-out financial statements are prepared. As a result, depreciation that was not recognised in respect of property, plant and equipment held for sale in the consolidated financial statements will be recognised in the combined and/or carve-out financial statements.



Example 4D – Assets held for sale

Construction Company S specialises in the construction of new luxury apartment buildings and refurbishment of existing buildings. S has three divisions located in Europe, North America and the Middle East consisting of several subsidiaries.

S prepares its consolidated financial statements in accordance with IFRS.

In August 2015, the management of S committed to sell the refurbishment division located in Europe within the next 12 months, therefore meeting the requirements in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. In the consolidated financial statements for the year ended 31 December 2015, the subsidiaries that constitute the European refurbishment division are treated as a disposal group held for sale.

In March 2016, S's management decides to spin off the entire refurbishment business in order to focus on the construction of new luxury apartment buildings.

As part of the preparation for the IPO transaction, management prepares carve-out financial statements for financial years 2014 and 2015. Because the refurbishment business (including the European, North American and Middle Eastern divisions) represents the economic activity of the carve-out financial statements and there is no intention to separate the European division after the IPO transaction, there is no disposal group identified as held-for-sale in the carve-out financial statements of the refurbishment business.

Assets held for sale (or distribution)

Assets (and related liabilities) are classified as held-for-sale or held-for-distribution in the statement of financial position in the combined and/or carve-out financial statements if they meet the relevant criteria in IFRS 5. Guidance on assets held for sale or distribution is included in 5.4.05 in *Insights into IFRS*.



Example 4E – Assets held for sale

Continuing Example 2B, Company C is preparing carve-out financial statements for an IPO of its 40 profitable health clubs. However, the carve-out financial statements include the additional 10 loss-making health clubs to show management's track record in running the operations (see Chapter 2.3). These additional 10 health clubs will not be transferred to the listing vehicle, Newco.

The 10 health clubs are not held for sale because their carrying amount will not be recovered principally through a sale. Instead, from the perspective of the carved-out reporting entity they will be distributed to the larger reporting entity (parent). Therefore, they may meet the criteria to be classified as held-for-distribution in the combined and/or carve-out financial statements.

Accordingly, the health clubs are presented as follows in the statement of financial position.

- The assets and liabilities of the 40 successful health clubs are presented on various line items in the usual way.
- The assets of the 10 loss-making health clubs are presented as a single line item 'Assets held for distribution' (current assets) from the date of classification as held-for-distribution (comparatives are not represented).
- The liabilities of the 10 loss-making health clubs are presented as a single line item 'liabilities held for distribution' (current liabilities) from the date of classification as held-for-distribution (comparatives are not represented).

Discontinued operations

The definition of a discontinued operation in IFRS 5 is fairly restrictive – i.e. a separate major line of business or geographic area of operations. It is therefore not common for discontinued operations to be reported in combined and/or carve-out financial statements under IFRS. Guidance on discontinued operations is included in 5.4.120 in *Insights into IFRS*.

4.8.20

Transaction costs

Combined and/or carve-out financial statements are often prepared in conjunction with, or in anticipation of, an M&A transaction, spin-off or IPO. Relevant transaction costs that might be incurred include legal, consultancy, accounting or auditing fees.

In this situation, management first determines whether the costs are attributable to the combined/carved-out reporting entity directly. This is typically determined by analysing the nature of the costs – e.g. advisory work on how the larger reporting entity can maximise value in a sale (attributable to the larger reporting entity) vs advisory work on how the combined/carved-out reporting entity should be structured after the transaction (attributable to the combined/carved-out reporting entity). In many cases, a degree of judgement will be required in making this determination.

Having determined the transaction costs that should be recognised in the combined and/or carve-out financial statements, the accounting follows the usual principles. Expenditure such as audit fees related to the audit of the combined and/or carve-out financial statements is expensed as it is incurred.

Costs incurred in issuing debt securities that meet specific criteria are included in the initial measurement of the liabilities, assuming that they are not classified as at fair value through profit or loss. These criteria and the related accounting are discussed in 7.6.30 in *Insights into IFRS*.

Costs incurred in issuing shares that meet specific criteria are deducted from equity. The criteria include a requirement for new shares to be issued; these and the related accounting are discussed in 7.3.490 in *Insights into IFRS*.

Insights 7.3.510

Of particular relevance to combined and/or carve-out financial statements are equity transaction costs incurred before the equity instrument is issued. IFRS is silent on how to account for these costs before the equity transaction has been recorded. In the case of generic financial statements the guidance and interpretations included in *Insights into IFRS* are applicable. *Insights into IFRS* states that, in our view, costs that are related directly to a probable future equity transaction should be recognised as a prepayment (asset) in the statement of financial position of the combined and/or carve-out financial statements. They should be transferred to equity when the equity transaction is recognised, or recognised in profit or loss if the issue is no longer expected to be completed. Whether the 'probability' test is met when the transaction costs are incurred may require significant judgement in the context of combined and/or carve-out financial statements.

4.8.30

Earnings per share

IAS 33.2

IAS 33 *Earnings per Share* applies to entities whose ordinary shares or potential ordinary shares are traded in a public market or that file or are in the process of filing their financial statements with a securities commission or other regulatory organisation for the purpose of issuing and/or registering ordinary shares on a public market.

Based on these criteria, the combined/carved-out reporting entity is not typically required to present earnings per share (EPS) information. However, the combined and/or carve-out financial statements are often used in conjunction with a capital markets transaction – e.g. an IPO or a registration of shares with no offering of new shares. In this case, some regulators request EPS information based on historical earnings and the targeted capital structure. In our experience, in this case regulators in some jurisdictions request EPS presentation based on the following method.

The denominator in the calculation of basic EPS for each period presented is the number of shares planned to be issued on formation of the new IPO vehicle as at the effective date of the registration statement that includes the combined and carve-out financial statements. The calculation of diluted EPS takes into account the dilutive effects of the combined/carved-out reporting entity's options and/or convertible instruments from the date on which they are granted; however, the calculation does not consider any dilutive impact arising at the level of the larger (parent) group.

The resulting EPS data is pro forma rather than historical (see Section 1) and should be indicated as such in the combined and/or carve-out financial statements. General guidance on the calculation of EPS is included in Chapter 5.3 of *Insights into IFRS*.

4.8.40

IFRS 8.2

Operating segments

IFRS 8 *Operating Segments* applies to entities whose debt or equity instruments are traded in a public market or that file or are in the process of filing their financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

IFRS 8.A

IFRS 8 requires the disclosure of information about the nature and financial effects of the business activities in which an entity engages, as well as the economic environment in which it operates. It requires segment disclosure based on the components of the entity that management monitors in making decisions about operating matters. In order to determine the operating segments, there needs to be evidence that the operating results have been regularly reviewed by the chief operating decision maker (CODM) to make decisions about resources to be allocated to a segment and assess its performance – e.g. the operating segments identified in the combined and/or carve-out financial statements have historically been separately tracked and monitored.

The CODM may not be as clearly identifiable for the combined/carved-out reporting entity as for the larger reporting entity. In practice, the CODM is usually the highest level of management within the group who is responsible for the combined/carved-out reporting entity after completion of the transaction – e.g. the IPO.

Management determines the reporting structure and operating segments of the combined/carved-out reporting entity based on reporting and oversight by the CODM – in particular, in cases where the reporting structure of the combined/carved-out reporting entity differs from that of the parent.

In our experience, if the reporting structure at the level of the combined/carved-out reporting entity has existed throughout the whole reporting period, then operating segment disclosures adding information on segments in the combined and/or carve-out financial statements may be required by regulators. By contrast, if the larger reporting entity has not had a reporting structure reflecting the segments

that are included in the combined and/or carve-out financial statements and the cost to develop the information would be excessive, then operating segment disclosures are not typically required.

Guidance on the presentation of segment information is included in Chapter 5.2 in *Insights into IFRS*.

4.8.50

Statement of cash flows

The combined and/or carve-out financial statements need to include statements of cash flows prepared in accordance with IAS 7 *Statement of Cash Flows*.

The most significant difference between a statement of cash flows for a stand-alone business and that for a combined/carved-out reporting entity relates to the cash flows from financing activities. This difference is driven by the presentation of equity in the statement of financial position, which frequently displays a line item 'net parent investment' in the combined and/or carve-out financial statements, rather than the typical line items such as share capital, additional paid-in capital or retained earnings (see Chapter 4.7).

In many cases, the combined/carved-out reporting entity has historically relied on the parent to fund its operations through participation in the parent's cash management or debt financing programmes (see 4.5.50). These cash flows to and from the parent have changed the parent's investment in the reporting entity and the 'net position' may be presented in the equity section of the combined and/or carve-out statement of financial position. This relationship needs to be presented appropriately in the financing section of the combined and/or carve-out statement of cash flows.

In some cases, management may feel that a statement of cash flows prepared on this basis, although it accurately shows movements between the opening and closing balance of cash and cash equivalents in the combined and/or carve-out financial statements, does not reflect the operational cash inflows and outflows of the business. In this case, management can consider presenting supplementary cash flow information that includes the cash flows of the parent that are attributable to the combined/carved-out reporting entity and are now subsumed within the net position in equity.

The parent may have directly paid cash for interest due and then charged the subsidiary (component) for the expense incurred on its behalf. If the financial liabilities to which those interest payments relate are recognised in the combined and/or carve-out statement of financial position (see 4.5.30), then the cash flows (payments) related to this interest expense are presented as cash outflows in the financing or operating section of the combined and/or carve-out statement of cash flows, based on the accounting policy elected.

General guidance on the presentation of the statement of cash flows is included in Chapter 2.3 in *Insights into IFRS*.

4.8.60



Subsequent events

Globally, we have observed three approaches that have been applied for subsequent events in combined and/or carve-out financial statements. Although the first two approaches would be more consistent with the principles of IFRS for generic financial statements, all three approaches may have some technical merits that make them appropriate for combined and/or carve-out financial statements,

depending on the facts and circumstances of the particular situation. However, the outcome may differ significantly depending on the chosen approach. The following approaches have been observed in practice.

- General approach.
- First-time adopter approach.
- Extraction approach.

General approach

IAS 10.3–8

The general approach for subsequent events follows the requirements that are included in IAS 10 *Events after the Reporting Period*. The combined and/or carve-out financial statements are adjusted to reflect events that occur after the reporting date but before the financial statements are issued. Following this approach, the combined and/or carve-out financial statements provide information on the conditions of the adjusting events that existed at the reporting date.

We have observed that combined and/or carve-out financial statements are generally prepared and authorised *after* the financial statements of the larger reporting entity (e.g. group) that includes the carved-out reporting entity. Under this approach, the combined and/or carve-out financial statements have their own date of authorisation, which differs from that for the consolidated financial statements of the larger reporting entity. Therefore, when preparing the combined and/or carve-out financial statements management considers events up to the date of authorisation of those financial statements (i.e. including those that occurred after the authorisation date of the consolidated financial statements of the larger reporting entity).

Insights 2.9.15

This approach is consistent with the application of IFRS to generic financial statements.

First-time adopter approach

Under this approach, the carved-out reporting entity is considered to be a first-time adopter of IFRS and, consequently, IFRS 1 is applied.

IFRS 1.14–15

IFRS 1 includes a mandatory exception on how to deal with changes in estimates that in effect modifies the guidance in IAS 10. Estimates made in preparing an entity's first IFRS financial statements at the date of transition and at the end of the comparative reporting period are consistent with estimates made under previous GAAP. Therefore, they are not updated for information received at a later date. If changes in estimates are appropriate, then they are accounted for prospectively.

The following are the only exceptions to this requirement (see 6.1.190 in *Insights into IFRS*).

- The entity may need to make estimates that were not required under previous GAAP because different accounting policies are elected on adoption of IFRS – in particular, estimates of market prices, interest rates or foreign exchange rates that need to reflect market conditions on the date of adoption.
- There is objective evidence that the estimate under previous GAAP was in error. A prior-period error is an omission or misstatement arising from the failure to use, or the misuse of, reliable information that was available when the financial statements for that period were authorised for issue and could reasonably be expected to have been obtained and taken into account.

IFRS 1.16, IAS 8.5

Sometimes this approach is considered to have a significant advantage when a subsequent event occurs, compared with the general approach. Under the general approach, all events are considered from the reporting date to the date on which the financial statements are authorised for issue. The implication is that all reporting periods (i.e. the current and the comparative periods) would remain 'open' until the combined and/or carve-out financial statements are authorised for issue.

Under the 'first-time adopter approach', however, the comparative periods are 'closed', given that the comparative periods need to be consistent with estimates made under previous GAAP. Consequently, only the current period remains 'open' to reflect subsequent events until the combined and/or carve-out financial statements are authorised for issue.

Insights 6.1

This approach is consistent with the principles of IFRS applied to IFRS first-time adopter generic financial statements. Therefore, this approach may be used if the overall approach is followed, as described in 3.2.10.

Extraction approach

An alternative approach that we have observed in practice is the extraction approach, which may have technical merit solely for the purpose of combined and/or carve-out financial statements.

Under this approach, a carved-out reporting entity is considered a reflection of the larger reporting entity (e.g. group). The financial information of the carved-out reporting entity has been included in the consolidated financial statements of the larger reporting entity and, therefore, approved and issued.

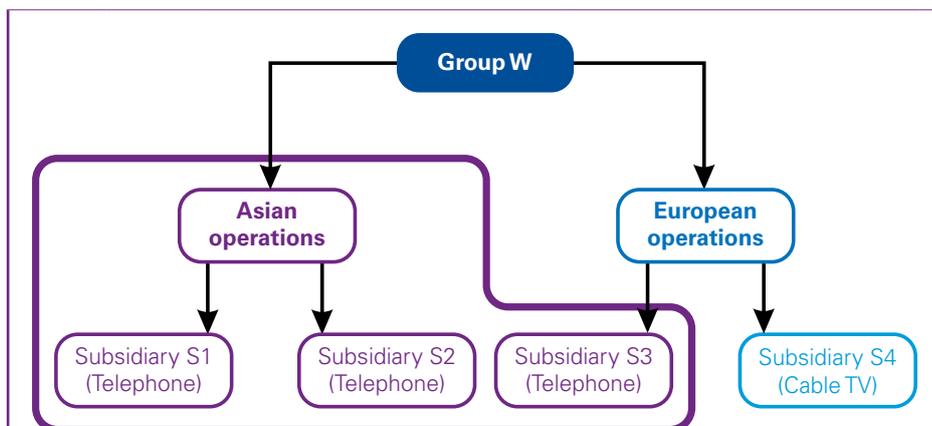
We have observed in practice that the financial information is extracted from the consolidated financial statements of the larger reporting entity and as a consequence combined and/or carve-out financial statements prepared under this approach do not include any information about events after the date of issue of the consolidated financial statements.

Globally, we also noted that some jurisdictions follow the described extraction approach when applying IFRS 1. To be aware of the predominant practice in your jurisdiction, we recommend consulting your KPMG professional.



Example 4F – Subsequent events

Group W operates in multiple jurisdictions and has two divisions: Asia and Europe. The Asian division has two subsidiaries (Subsidiaries S1 and S2), which focus on telephone services. The European division has one subsidiary that focuses on telephone services (Subsidiary S3), and one subsidiary that focuses on cable TV services (Subsidiary S4). W prepares its consolidated financial statements in accordance with IFRS.



W wishes to carve out and sell its telephone services in an IPO, and is required by regulation to prepare IFRS combined and/or carve-out financial statements for the telephone services. This involves combining the Asian division, including S1 and S2, with a portion of the European division, including S3.

The combined and/or carve-out financial statements will cover the year ended 31 December 2016, with 2015 comparatives. Management has gathered information on subsequent events to be able to prepare the combined and/or carve-out financial statements. The following information is also relevant for this example.

- A supplier has a dispute with the telephone division. On 30 November 2015, the supplier sued the telephone division for a breach of a contract.
- W asserted in its 2015 consolidated financial statements that it had not breached the contract and had legal opinions supporting this as the most likely outcome.
- W's 2016 consolidated financial statements include disclosure of a contingent liability in respect of the legal claim made by the supplier.
- W authorises its 2016 consolidated financial statements for issue on 10 March 2017. As at that date, management assesses that W will successfully defend the claim in court.
- On 20 April 2017, the court rules in the supplier's (claimant's) favour and awards damages of 10 million. W's management considers this an adjusting event for both W and the telephone division.
- On 25 August 2017, management authorises the combined and/or carve-out financial statements for issue.

The following table compares the effects of the court ruling as a subsequent event on the telephone operations' combined and/or carve-out financial statements, depending on the approach that is applied.

	Current period: 2016	Comparative period: 2015
General approach	Continue to recognise a liability (with corresponding amount now in retained earnings)	Recognise an expense in profit or loss and a corresponding liability (10 million), because the subsequent event period for the 2015 (and 2016) combined and or carve-out financial statements ends after the court ruling
First-time adopter approach	Recognise an expense in profit or loss and a corresponding liability/ payment (10 million)	Do not recognise the subsequent event. Disclosure of the amount recognised in 2016 would identify that it related to the claim received in 2015
Extraction approach	No change from W's consolidated financial statements – disclose a contingent liability	No change from W's consolidated financial statements. The court ruling is not disclosed because it occurred after the date of authorisation of W's 2016 consolidated financial statements

5

Disclosures

To comply with IFRS, the combined and/or carve-out financial statements need to include all of the disclosures required by IFRS; these are listed in our publication [Guide to financial statements: Disclosure checklist](#). This section does not repeat these requirements, but instead focuses on specific disclosure issues related to combined and/or carve-out financial statements.

At a minimum, the combined and/or carve-out financial statements have to include disclosures on the following:

- the framework under which the financial statements have been prepared;
- what the financial statements purport to represent;
- the fact that the components are part of a larger reporting entity, and the nature of the relationship between the combined/carved-out reporting entity and the larger reporting entity;
- the criteria used in defining the components included in the combined/carved-out reporting entity; and
- the approach and methodology for all significant allocations made in preparing the financial statements.

5.1

Boundaries of the reporting entity

Information about the boundaries of the reporting entity is one of the most important disclosures in a set of combined and/or carve-out financial statements, because it explains the scope of the reporting entity and helps the reader to understand the context in which the financial statements have been prepared. For a discussion of the factors to be considered in determining the boundaries of the reporting entity, see Section 2.

Disclosure 5A: OSRAM Licht Group

The following disclosure extract sets out the definition of the economic activities that form the combined/carved-out reporting entity and its relationship with the larger reporting entity.

Definition of the OSRAM business

OSRAM is one of the world's leading providers of lighting products and solutions. In addition to products and lighting solutions based on traditional technologies, OSRAM offers LEDs (light-emitting diodes), OLEDs (organic light emitting diodes) and products based on LED, which OSRAM subsumes under the term SSL (solid state lighting). These include inter-alia retrofit lamps (LED lamps in the traditional form and which are direct substitutions for the traditional light bulbs), SSL systems and SSL luminaires for various applications. The product portfolio using traditional technologies includes halogen lamps, compact fluorescent lamps (CFL, energy saving lamps), linear fluorescent lamps, high intensity discharge lamps (e.g. metal halide lamps on a quartz or ceramic basis), traditional incandescent lamps, as well as electronic ballasts and dimmers for both traditional and LED-based products. In addition, OSRAM offers customized solutions and light management systems for large projects. OSRAM's products are used for illumination, visualization, sensing and various other purposes in a wide variety of applications.

OSRAM operates worldwide in legal entities and was presented as a Division of the Industry Sector (business segment within Siemens) in Siemens' Consolidated Financial Statements. Since March 31, 2011 OSRAM has been classified as held for disposal and presented as discontinued operation in Siemens' Consolidated Financial Statements.

Source: OSRAM Licht AG, [Listing Prospectus \(English translation\)](#), page F-42.

Disclosure 5B: Telefónica Germany Group

The following disclosure extract explains the economic activities that form the combined/carved-out reporting entity and includes a group structure that illustrates its relationship with the larger reporting entity.

Basis of preparation

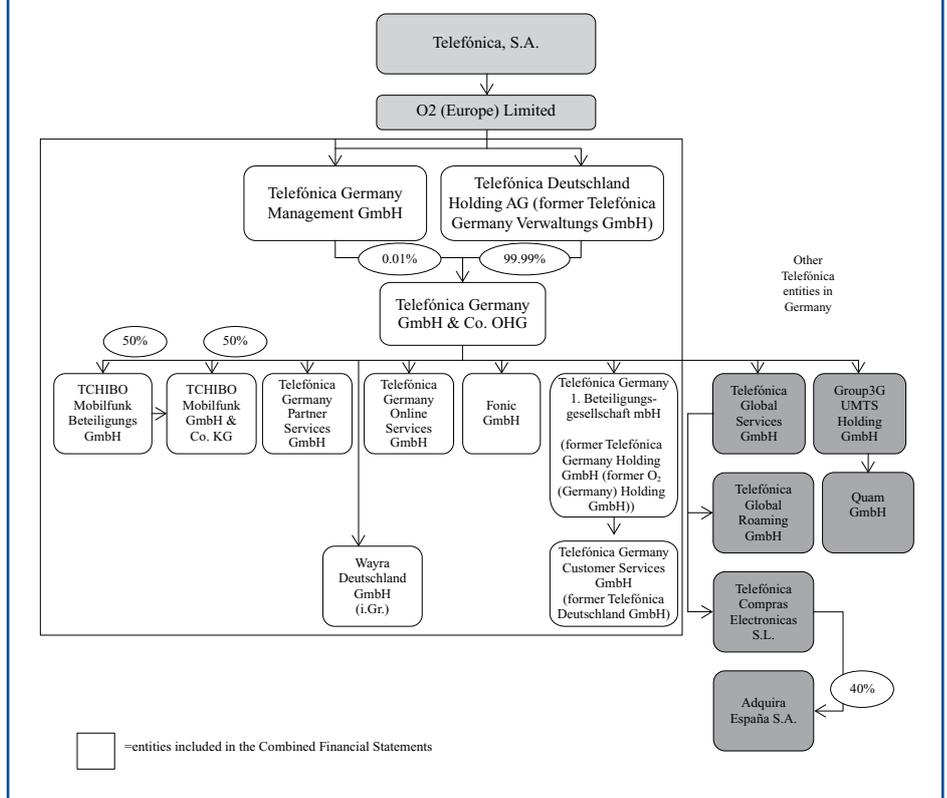
Telefónica Germany Group comprises Telefónica's operations in Germany. Telefónica Germany Group is one of only three integrated network operators in Germany having both a wireline and wireless network. It offers its consumer retail and business customers post-paid and prepaid wireless communications products, along with wireless data services using Global Packet Radio Service ("GPRS"), Universal Mobile Telecommunications System ("UMTS") and Long Term Evolution ("LTE") technology, as well as, DSL wireline telephony and high-speed internet services.

Telefónica Germany Group primarily distributes its O2 branded services offering through a network of own operated and franchised shops, its wholesale and other distribution partners and via its O2 internet portal. Telefónica Germany Group is managed centrally by the Management Board of the Telefónica Deutschland Holding AG (former "Telefónica Germany Verwaltungs GmbH") located in Georg-Brauchle-Ring 23-25, 80992 München.

The purpose of these Combined Financial Statements is to provide general purpose historical financial information of Telefónica Germany Group for the inclusion in the prospectus for the initial public offering and for the admission to the regulated market. Therefore, the Combined Financial Statements present only the historical financial information of those entities that will be part of Telefónica Germany Group at the time of the intended initial public offering.

Scope of the entities included in the combined financial statements

As of December 31, 2011, the legal entities of Telefónica in Germany are organized as illustrated in the following organizational chart (for historical development see Appendix II):



Source: Telefónica Deutschland Holding AG, [Prospectus, pages F-22–F-23](#).

Disclosure 5C: Welsh Predecessor Properties (WPT Industrial REIT)

The following disclosure extract explains that the combined and/or carve-out financial statements have been prepared based on common management (see Chapter 2.2).

General information

The Welsh Predecessor Properties as presented in these combined financial statements are not a legal entity. It represents the combination of 15 industrial and two office properties (the “Portfolio”), located in various regions throughout the United States. For all periods presented in these combined financial statements, the Portfolio was under the management of the same three principals of the Welsh group of companies (“The Welsh Group”) and are therefore considered to be under common management. Management believes that combination under the basis of common management is appropriate for the Portfolio given the three principals serve in executive level positions for all investment properties combined in the accompanying financial statements, one of whom serves as the Chief Executive Officer in all instances.

In this Chief Executive role, the principal provides general and active management of the business of the Portfolio and sees that all orders and resolutions of the members and managing member are carried into effect and possesses the general powers and duties of management usually vested in the chief manager of a limited liability company. These executive level appointments are contractual in nature. The three principals have held these executive level positions for the entire period presented in the accompanying combined financial statements. Additionally, ten of the 17 investment properties comprising the Portfolio are under the common control of the Chief Executive Officer. The ultimate owners of the Portfolio are the principals of The Welsh Group and certain other investors who have varied ownership interests.

Source: WPT Industrial Real Estate Investment Trust, [Prospectus, page F-68](#).

Disclosure 5D: Philips Lighting

The following disclosure extract sets out the process that management has followed to establish the boundaries of the combined/carved-out reporting entity, including elements of allocation between the larger reporting entity and the combined/carved-out reporting entity.

Particulars of the business

On 23 September 2014, Koninklijke Philips N.V. (referred to as Royal Philips) announced its plan to sharpen its strategic focus by establishing two stand-alone companies focused on HealthTech and Lighting opportunities. The establishment of the two stand-alone companies also involves the allocation of elements of the Philips Innovation, Group & Services Sector (“IG&S”) to each company.

To achieve this transformation, Royal Philips started the process to separate its existing lighting business (except for the combined LED and automotive lighting components businesses) into a separate legal structure and considering various options for ownership structures that would have direct access to capital markets. For this purpose, Royal Philips transferred to Philips Lighting Holding B.V., the equity interests of certain entities that operate the lighting businesses, as well as assets and liabilities allocated to it (“Philips Lighting”). The legal separation of the lighting business was substantially completed on 1 February 2016, with the exception of certain delayed transfers.

Philips Lighting, comprising the former Lighting Sector of the Royal Philips group and the Lighting-related activities of IG&S, historically did not exist as a separate legal and reporting group and no separate (statutory) financial statements were therefore prepared. Accordingly, for purpose of the evaluation of the historical financial results of the Philips Lighting business and the preparation for capital markets access, Combined Financial Statements of Philips Lighting for the years 2013, 2014 and 2015 have been prepared.

Source: Philips Lighting, [Prospectus, page F-22](#).

5.2

Overall approach to preparing the financial statements

The following disclosures highlight the source of the financial data used to prepare the combined and/or carve-out financial statements and whether IFRS 1 has been applied. For a discussion of the overall approach to preparing combined and/or carve-out financial statements, see Section 3.

Disclosure 5E: OSRAM Licht Group

The following disclosure extract explains that the combined financial statements have been prepared based on the financial information of the larger reporting entity, which already prepares its consolidated financial statements in accordance with IFRS, and that IFRS 1 has been applied.

Combined financial statements

OSRAM Licht Group has prepared these Combined Financial Statements in accordance with International Financial Reporting Standards (“IFRS”) as adopted by the European Union (“EU”).

These Combined Financial Statements are the first financial statements of OSRAM Licht Group in accordance with IFRS 1.3. OSRAM Licht Group prepared the Combined Financial Statements using IFRS 1.D16(a) (“predecessor accounting method”). OSRAM Licht Group used the same accounting policies and valuation methods for the preparation of these Combined Financial Statements, as those used by the OSRAM companies for the preparation of the financial information included in Siemens’ Consolidated Financial Statements, unless such accounting policies and valuation methods are not in accordance with IFRS when presenting OSRAM Licht Group as a group of companies independent of Siemens. These accounting policies have been disclosed under Note 2 *Summary of significant accounting policies*. The Combined Financial Statements were prepared on a historical cost basis as included in Siemens’ Consolidated Financial Statements, based on Siemens’ date of transition to IFRS (October 1, 2004).

Source: OSRAM Licht AG, [Listing Prospectus \(English translation\), page F-43](#).

Disclosure 5F: OrthoRecon Business (MicroPort Scientific Corporation)

The following disclosure extract explains that the combined and/or carve-out financial statements have been prepared based on the financial information of the larger reporting entity, which has not previously applied IFRS. Therefore, IFRS 1 has been applied by the larger reporting entity to provide the base data for the combined carve-out financial statements.

Basis of Preparation

The Financial Information set out in this report has been prepared in accordance with International Financial Reporting Standards (“IFRS”). IFRS 1, First-Time Adoption of International Financial Reporting Standards (“IFRS 1”) has been applied in the adoption of IFRS for the purpose of preparing the Underlying Financial Statements and the Financial Information. The transition date is 1 January 2010 (the “Transition Date”). The Business has never prepared financial statements or financial information on the basis of preparation presented herein and on any other basis for the OrthoRecon business. Prior to the first-time adoption of IFRS, the financial information of the Business included in this report was reflected in Wright Medical’s consolidated results and was prepared in accordance with accounting principles generally accepted in the US.

Certain optional exemptions and certain mandatory exceptions as applicable for first-time IFRS adopters have been applied in preparing the Financial Information of the Business. Estimates made in preparing the Financial Information reflect the facts and circumstances which existed at the time such estimates were made.

The following optional exemptions of IFRS 1 have been applied in preparing the Financial Information set out in this report:

- (i) IFRS 1 provides relief from full retrospective application that would require restatement of all business combinations prior to the Transition Date. IFRS 3 (revised 2008), Business Combinations, has been applied prospectively from the Transition Date. Therefore, business combinations occurring prior to the Transition Date have not been restated.
- (ii) IFRS 1 permits cumulative translation gains and losses to be reset to zero upon transition to IFRS. Cumulative foreign currency translation gains and losses are reset to zero in opening Parent’s Net Investment at the Transition Date.
- (iii) In accordance with the exemption under IFRS 1, only share-based awards not vested at the Transition Date under IFRS 2, Share-based Payment, have been accounted for.

Since no financial statements of the Business has previously been prepared, the Financial Information set out in this report do not include any IFRS 1 first time adoption reconciliations.

Source: MicroPort Scientific Corporation – OrthoRecon Business, [Circular 15 December 2013, pages 11–12](#).

Disclosure 5G: Philips Lighting

The following disclosure extract sets out the process that management has followed in order to establish the boundaries of the combined/carved-out reporting entity, including elements of allocation between the larger reporting entity and the combined/carved-out reporting entity.

Introduction to the combined financial statements

As Philips Lighting has not previously prepared stand-alone financial statements, these Combined Financial Statements are the first IFRS financial statements of Philips Lighting in which IFRS 1 (First-time Adoption of International Financial Reporting Standards) has been applied. IFRS 1 sets out the procedures that an entity must follow when it adopts IFRSs for the first time as the basis for preparing its general purpose financial statements. As a first-time adopter, Philips Lighting has applied the exemption under IFRS 1.D13(a) to deem the cumulative foreign exchange differences to be zero at January 1, 2013 (the date of transition). Since Philips Lighting did not previously prepare combined financial statements, and accordingly does not have any previous GAAP for purposes of the combined financial statements, Philips Lighting is not required to present reconciliations as per IFRS 1.

The accounting policies applied in the Combined Financial Statements are, to the extent applicable, consistent with accounting policies applied in the Philips Group Consolidated Financial Statements. As a result, the Combined Financial Statements have been prepared according to IFRS 1.D16(b) and, apart from the applied exemption under IFRS 1.D13(a), reflect the carrying amounts that are included in Philips Group Consolidated Financial Statements.

The Combined Financial Statements have been prepared on a “carve-out basis” from the Philips Group Consolidated Financial Statements for the purpose of presenting the financial position, results of operations and cash flows of Philips Lighting on a stand-alone basis, as explained in section C, Basis of Preparation, below.

Source: Philips Lighting, [Prospectus, pages F22–F23](#).

5.3

Accounting policies and estimates

The following disclosures highlight the assumptions and estimates made in preparing the combined and/or carve-out financial statements (see Section 4).

Disclosure 5H: Philips Lighting

The following disclosure sets out which assets and liabilities portray the combined/carved-out reporting entity. Furthermore, a disclosure is included about the allocation of general charges between the larger reporting entity and the combined/carved-out reporting entity.

C. Basis of preparation

1. General

These Combined Financial Statements present the Philips Lighting business of Philips Group, representing the activities, assets and liabilities of the Philips Lighting Sector and the Lighting-related activities of the Philips IG&S Sector that relate to or have been assigned to the Philips Lighting business. The Combined Financial Statements reflect the substance of the activities, assets and liabilities attributable to Philips Lighting. The legal structure was not considered the key factor in determining the perimeter of the Combined Financial Statements, but rather the basis of the economic activities.

The Combined Financial Statements have been prepared on a “carve-out basis” from the Philips Group Consolidated Financial Statements for the purpose of presenting the financial position, results of operations and cash flows of Philips Lighting on a stand-alone basis. The Combined Financial Statements present the assets, liabilities, revenues, expenses and cash flows attributable to Philips Lighting for the years ended 31 December 2015, 2014 and 2013. The Combined financial statements have been prepared under the historical cost convention, unless otherwise indicated. The fair value of financial assets and liabilities is presented in note E.31.

Transactions and balances previously reported as part of the continuing operations of the Philips Lighting Sector have been directly attributed to Philips Lighting. Transactions and balances previously reported as part of IG&S have been attributed to Philips Lighting based on specific identification or allocation. Allocations were made using relative percentages of net sales, headcount, floor area usage or other methods, which are considered reasonable under the circumstances and further explained below.

Combined Balance Sheets

The Philips Lighting Combined Balance Sheets include the assets and liabilities previously reported as part of the Philips Lighting Sector as well as the Lighting-related assets and liabilities of the Philips IG&S Sector, which have been determined in the following manner:

- Property, plant and equipment ('PP&E'): PP&E held centrally in IG&S have been assigned fully to either Philips Lighting or Philips Group based on main user of the asset.
- Intangible assets held in IG&S mainly comprise IT related assets, which have been allocated between Philips Lighting and Philips Group based on relative usage.
- Receivables: unless balances could be specifically assigned to either Philips Lighting or Philips Group, these were allocated based on the relative percentage of net Philips Lighting or net Philips Group sales of IG&S, which approximates allocation on an item-by-item basis.
- Trade and other payables: unless payables could be specifically assigned to either Philips Lighting or Philips Group, these balances are allocated to either Philips Lighting or Philips Group based on the relative percentage of the external costs in IG&S, which approximates allocation on an item-by-item basis.
- Accrued liabilities: unless accruals could be specifically assigned to either Philips Lighting or Philips Group, these were allocated based on headcount or using a cost allocation ratio depending on the specific nature of the balance.

Combined Statements of Income

Philips charges central IG&S costs, such as IT, finance and accounting, HR, real estate and other central support services, to its sectors mainly based on activity (headcount, floor area, etc.), sales or gross margin. Historically, a significant portion of the IG&S costs were already charged to the Lighting Sector. The combination of the Lighting-related activities of IG&S mainly resulted in additional allocation of previously unallocated costs to Philips Lighting. Previously unallocated costs mainly comprise Group funded research programs, Group overhead and other items such as restructuring and foreign exchange results. The allocation to Philips Lighting of previously unallocated costs is based on activity.

Group-funded research costs were allocated according to the project-level administration of the business for which the activity has been performed. Group overhead includes central finance functions including treasury and tax, human resources, strategy, business transformation, brand, communication & digital, legal and general management including the Philips Executive Committee. The costs of Group overhead have been allocated based on estimated activity levels and the relation of these functions to Philips Lighting and Philips Group.

Other items of IG&S, such as restructuring costs, foreign exchange results and other items, have been allocated to Philips Lighting based on its relative share in overall costs of IG&S.

Employee benefit expenses and other operational costs were allocated to Philips Lighting based on activity. Depreciation and amortization were assigned to Philips Lighting based on the split of related assets. Interest expense recorded in the Combined Statements of Income does not include any allocation of interest incurred by Philips Group or interest on funding provided as part of the owner's net investment.

Source: Philips Lighting, [Prospectus, pages F23-F24](#).

Disclosure 5I: OrthoRecon Business (MicroPort Scientific Corporation)

The following disclosure explains the process followed in allocating assets, liabilities and costs to the combined financial statements.

General information

During the Relevant Periods, the Business functioned as part of the larger group of companies controlled by Wright Medical, and accordingly, a process has been completed to specifically identify assets, liabilities, revenues, expenses and cash flows associated with the Business in preparing the Financial Information. Assets, liabilities and costs that were related to the larger business of Wright Medical were also assessed to allocate these items between OrthoRecon business and the rest of the business of Wright Medical. This allocation has been completed based on the following general process:

- Corporate overhead functions performed for the Business – These functions include, but are not limited to, executive oversight, legal, finance, human resources, internal audit, financial reporting, and tax planning. The costs of such services have been allocated to the Business based on the most relevant allocation method to the service provided, primarily based on relative percentage of revenue or headcount. Management of Wright Medical believes such allocations are reasonable; however, they may not be indicative of the actual expense that would have been incurred had the Business been operating as a separate entity apart from Wright Medical. The cost allocated for these functions is included in administrative expenses in the combined income statements for the Relevant Periods presented. A complete discussion of the Business's relationship with Wright Medical, together with the cost allocations, is included in Note 22.
- Corporate assets and other combined assets – There are certain shared assets the most significant of which are Wright Medical's capitalized software that is used by all businesses and surgical instruments. The Financial Information includes an allocation of these assets, primarily based on a relative percentage of revenue.
- Liabilities and other combined liabilities – There are certain liabilities that represent liabilities of the entire Wright Medical group that could not be specifically identified for each business. The most significant of these was accounts payable, which are combined due to the nature of how Wright Medical manages its accounts payable. An allocation method primarily based on relative percentage of revenue has been used.

The Company believes the basis of preparation described above results in the Financial Information reflecting the assets and liabilities associated with the Business and reflects costs associated with the functions that would be necessary to operate independently. However, as the Business did not operate as a stand-alone entity during the Relevant Periods, the Financial Information may not be indicative of the Business's future performance and do not necessarily reflect what its results of operations, financial position, and cash flows would have been had the Business operated as a separate entity apart from Wright Medical during the Relevant Periods.

Source: MicroPort Scientific Corporation – OrthoRecon Business, [Circular 15 December 2013, pages 11–13](#).

Disclosure 5J: OSRAM Licht Group

The following disclosure extract explains the general principle that the combined and/or carve-out financial statements have been prepared as an aggregation of certain subgroups within the larger reporting entity, and states that transactions with the larger reporting entity are related party transactions for the purposes of these combined and/or carve-out financial statements.

The combined financial statements of OSRAM Licht Group have been derived from the aggregation of the net assets of OSRAM Licht AG, OSRAM Beteiligungen GmbH as well as OSRAM GmbH and its direct and indirect subsidiaries. All intra-group balances, income, expenses and unrealized gains and losses arising from transactions between companies belonging to OSRAM Licht Group were eliminated when preparing the combined financial statements. In addition, the investments of the holding companies of OSRAM Licht Group were eliminated against the equity of the respective subsidiaries. Transactions with Siemens AG and Siemens Group companies, which do not belong to OSRAM Licht Group, have been disclosed as transactions with related parties.

Source: OSRAM Licht AG, [Listing Prospectus \(English translation\)](#), page F-44.

Disclosure 5K: OSRAM Licht Group

The following disclosure extract explains the assumptions made in respect of income taxes in the combined and/or carve-out financial statements.

Notes to the financial statements

Income taxes were determined based on the assumption that the companies in OSRAM Licht Group were separately taxable entities. This assumption implies that the current and deferred income taxes of all companies and of the tax groups within OSRAM Licht Group are calculated separately and the recoverability of the deferred tax assets is also assessed accordingly. Due to the fact that certain entities of OSRAM Licht Group did not file separate tax returns in previous years, the respective current tax assets and liabilities, as well as the deferred tax assets on net operating losses, are deemed either contributed or distributed to the respective tax group member filing the tax return with a corresponding effect in the equity of the (non-OSRAM Licht Group) shareholder as of the end of the respective fiscal year. The taxes actually paid by the OSRAM Licht Group have been presented in the Combined Statements of Cash Flow; the deemed contributions or distributions have not been included. In fiscal 2012 all companies of OSRAM Licht Group were either separately taxable entities or were part of an income tax group within OSRAM Licht Group. Receivables and payables between OSRAM GmbH and Siemens arising from the VAT group have been disclosed under other tax receivables / payables.

Income taxes—The Company applies IAS 12 Income taxes. Current taxes are calculated based on the profit (loss) of the fiscal year and in accordance with local tax law of the respective tax jurisdiction. Expected and executed additional tax payments respectively tax refunds for prior years are also taken into account. Under the liability method, deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the Combined Statements of Income, unless related to items directly recognized in equity, in the period the new laws are enacted or substantively enacted. Deferred tax assets are recognized to the extent that it is probable that future taxable income will be available against which the deductible temporary differences, unused tax losses and unused tax credits can be utilized. See additional information in Note 1 *Basis of preparation*.

Source: OSRAM Licht AG, [Listing Prospectus \(English translation\)](#), pages F-44 and F-49.

6

Practical considerations

Preparing combined and/or carve-out financial statements is a complex undertaking that can create significant practical challenges for management. In this section, we outline what some of these challenges are and how we have observed them being addressed in practice. KPMG professionals can provide support in dealing with these challenges. We therefore recommend that you consult your KPMG professional about the specific practical considerations relevant for the preparation process around combined and/or carve-out financial statements.

6.1 Project management

A project to prepare combined and/or carve-out financial statements is a complex undertaking that often requires the investment of significant human and financial resources over an extended period of time. Therefore, establishing a robust project management structure at inception of the project is an essential step to ensuring its success.

6.1.10 Establishing project governance

Management may establish the goals and objectives of the project to prepare combined and/or carve-out financial statements and commit them to a project charter.

Frequently, management will form a steering committee to serve as the decision-making body for the overall project. This committee comprises the executive sponsors who are providing significant resources to the project and are responsible for its success.

Management generally prepares a project timeline and identifies the human and financial resources needed for the project to achieve its goals and objectives. The identification of the internal human resources that are available will highlight any gaps that may need to be filled by outside suppliers. After the project timing and the resource needs are identified, management ordinarily secures sufficient budget for the project.

6.1.20 Assembling the project team

In most cases, the project steering committee designates an individual to serve as the project lead. Typically, this individual is responsible for the day-to-day management of the project and reports on progress to the project steering committee on a regular basis.

Projects to prepare combined and/or carve-out financial statements are frequently structured into several workstreams, each of which is responsible for a key component of the overall project. For example, a project may be divided into the following workstreams, each with a designated leader who reports to the overall project lead:

- project management;
- baseline numbers;
- IFRS compliance;
- corporate allocation;

- joint ventures, associates and structured entities;
- tax;
- regulatory, legal and compliance; and
- financial reporting.

For each workstream, management typically identifies which employees are best positioned to provide the data and other information required to prepare the combined and/or carve-out financial statements, and assign them to the relevant workstreams.

If management engages external advisers and resources, then key members of the external resources may be identified and mapped to the overall project team.

6.1.30

Developing a communication plan

As with most large projects, ensuring timely and adequate communication about the project among the project team, with key executive sponsors and more broadly within the organisation is critical to success.

A project communication plan may be developed that identifies the key project stakeholders, team members and other groups requiring communication. Then, for each identified party, the plan may specify the type of communication, frequency, location and purpose of the key project communication points.

The communication plan is usually monitored during the course of the project and modified to reflect changes in the project and changes in identified interested parties or their communication needs.

6.2

IT systems and data gathering

Due to the large amount of data generally required to develop combined and/or carve-out financial statements, IT solutions and existing infrastructure are generally at the forefront of management's plans. Management identifies an IT solution that balances its need to meet various management and reporting requirements with the need for a system that is separable, auditable, accessible and flexible, while still being cost-effective. The IT solution usually contemplates:

- the existing IT environment;
- business requirements for the combined and/or carve-out figures and financial statements; and
- the need to aggregate the data in a central location.

6.2.10

Common considerations

The following are common considerations for the IT environment.

- *Number of enterprise resource planning (ERP) systems and platforms:* Determine whether the new reporting entity's financial data is located within one ERP system and platform.
- *Existing ERP system(s)' ability to handle new relationships etc:* Assess the limitations of the existing ERP system(s) to adequately account for related party/ inter-company transactions, foreign exchange rates and issues with accessibility due to period-closing processes, period lock-outs or batch processing.

- *Ability to manage multiple reporting entities:* Understand the ERP system's ability to simultaneously manage the preparation of the combined and/or carve-out historical information and account for ongoing operations within the consolidated structure.
- *Need for a new ledger or environment:* Consider the need to create a new ledger or environment within the existing system, which may result in the need for additional IT systems, upgrades and/or licences, and the cost and effort required to implement the various data aggregation methods.
- *Level of detail:* Determine the level of detail with which the combined and/or carve-out financial statements will be created. Consider whether they will be developed at a summary level comprising subsidiaries, or at the lowest level of detail such as the legal entity trial balances.
- *Information for the data room:* IT systems may also be relied on to supply financial information for the data room – e.g. to support trend analysis, normalised earnings and other data room information, which may be aggregated on an annual, quarterly or monthly basis.
- *Accurate historical information:* Determine the adjustments needed to the trial balance data to achieve accurate historical financial statements.
- *Level at which entries will be posted:* The decision about the level at which to post entries generally depends on management's needs.
- *Audit considerations:* If the combined and/or carve-out financial statements will be audited, then management needs to ensure that the IT solution can provide an adequate audit trail of all trial balances and adjustments. See for more details about the audit of the combined and/or carve-out financial statements Chapter 6.7.

6.2.20

IT solutions

Companies generally use one or more of the following three particular IT solutions when preparing combined and/or carve-out financial statements:

1. set up a new book/ledger or test environment in an existing ERP system;
2. accumulate the data in an offline database system, such as SQL Server® or MS Access®; and
3. accumulate the data in a spreadsheet.

The choice is generally based on the facts and circumstances of the transaction, size and complexity of the transaction and (unincorporated) entities involved, and the functionality of the company's existing systems. Each has its strengths and weaknesses that may simplify or complicate the data aggregation. Your KPMG professional is able to advise you on the selection of an IT solution.

6.3

Central and shared services

Because combined and/or carve-out financial statements are typically prepared in anticipation of an IPO, sale or spin-off, a key business implication of the transaction is that the spin-off vehicle (i.e. Newco) will need to be able to function on its own without the same degree of support from its former group. Before the separation transaction, the business units may have benefited from central and shared services, which may no longer be available to them after separation.

Newco may therefore need to establish new systems and processes to replace the relinquished central and shared services of the group. The following are examples of functions that are often provided in this way.

Function	Newco may need to...
Payables and receivables management	<ul style="list-style-type: none"> – Create a new payables and receivables management function
Cash management/ treasury	<ul style="list-style-type: none"> – Open its own bank accounts – Establish its own treasury function
Information technology	<ul style="list-style-type: none"> – Create a new IT function and support desk – Negotiate a new contract with a third party IT service provider
Procurement	<ul style="list-style-type: none"> – Create a new procurement function – Negotiate new agreements with key vendors
General counsel	<ul style="list-style-type: none"> – Appoint a new general counsel – Engage a law firm to serve as outside counsel
Compliance	<ul style="list-style-type: none"> – Establish a new compliance function (especially if it has been created in contemplation of an IPO and needs to follow new listing requirements)
Internal audit	<ul style="list-style-type: none"> – Hire or identify new people to conduct internal audit work

In many cases, Newco may negotiate temporary service agreements with its former group to continue to access certain of the group's central and shared services for a period of time in exchange for arm's length fees until it can adequately replace those functions.

6.4

Supporting documentation

In preparing a set of combined and/or carve-out financial statements, it is important for management to create appropriate documentation that supports the statement that key assumptions, estimates and allocations are in line with IFRS as the basis of preparation of the financial statements.

At the start of a project, it is important for management to identify the parties that are expected to rely on the supporting documentation, and to identify their needs. For example, the documentation may be used by an entity's internal control and governance functions, may provide a record that will be leveraged in preparing financial statements for subsequent periods and/or may allow the company to respond to requests from external auditors and regulators.

For some aspects of preparing combined and/or carve-out financial statements, management may already have detailed supporting documentation for the calculations. This may be the case for areas in which the financial statements rely on information that was produced and relied on for other purposes within the organisation – e.g. compensation expense is often determined on an employee-by-employee basis.

However, for other aspects of preparing combined and/or carve-out financial statements, detailed supporting documentation may not yet exist. For example, management may need to allocate corporate overhead charges to the parts of the business that are being carved out, and this may be a new and previously undocumented process.

6.5

Involvement of other functions

Preparing combined and/or carve-out financial statements requires the involvement of professionals from more than just the accounting function. The following are examples.

- *Treasury* personnel are often needed to help separate the cash balances and related cash flows of the combined/carved-out reporting entity from those of the larger reporting entity.
- *Tax* personnel are often needed to help identify the tax attributes and balances that relate to the combined/carved-out reporting entity.
- *HR* personnel are often needed to help determine compensation costs that relate to the combined/carved-out reporting entity, including identifying reasonable bases of allocation of the costs of fringe benefits.
- *IT* personnel are often needed to help identify and extract relevant data from corporate systems, programme database queries and set up parallel instances of general ledgers and other key financial reporting systems to maintain accounting records for the combined/carved-out reporting entity.
- *Legal and compliance* personnel are often needed to help interpret contracts and arrangements between business units and to help understand and ensure compliance with relevant securities law and other applicable regulatory requirements.

Because the project to prepare combined and/or carve-out financial statements may be directed on a day-to-day basis from the accounting department, it is critical to secure the support and commitment to set project milestones of the leadership of the other functions that will need to be involved at the inception of the project.

6.6

Internal controls

Internal control is “a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.”⁴

Because the preparation of combined and/or carve-out financial statements is a reporting exercise, which is often undertaken at least in part to comply with regulations, and is frequently undertaken during a period of significant operational change, maintaining a robust internal control environment is critical to the success of the project.

The COSO *Integrated Framework* (2013) sets out components and principles that need to be present and functioning in an integrated manner to achieve effective internal control. It is important for management to consider how these components and principles of internal control may be applied and documented for the preparation of combined and/or carve-out financial statements.

Management will need to exercise its judgement in establishing an effective system of internal control for the preparation of combined and/or carve-out financial statements. The COSO *Integrated Framework* does not prescribe the specific controls that will be necessary, but rather sets out the principles that should be considered.

Key sources of information used in the preparation of combined and/or carve-out financial statements that originate beyond the boundaries of the organisation will need to be identified.

In many cases, an entity will be able to leverage existing internal controls relating to financial statement preparation, but some controls may need to be modified to reflect changes in processes. In addition, new internal controls and related processes may need to be developed for new activities involved in the preparation of combined and/or carve-out financial statements. For example, an entity may have created new processes to allocate various types of corporate overhead to the combined/carved-out reporting entity, which would require the development of new internal controls and processes.

6.7

Audit and reporting considerations

The preparation of combined and/or carve-out financial statements is challenging. Each transaction is different and each set of combined and/or carve-out financial statements will present a unique set of issues. Consequently, the audit of combined and/or carve-out financial statements generally involves more areas that require judgement from the independent auditor than an audit of generic financial statements. In our experience, it is important for management to communicate with their independent auditors as early as possible about the nature and content of the transaction that gives rise to the preparation of the combined and/or carve-out financial statements. Early two-way communication will enable the independent auditors to consider accounting and systems issues unique to such financial statements and their impact on the audit.

In the following table, we highlight some frequent considerations that are specific to the audit of combined and/or carve-out financial statements.

4. Committee of Sponsoring Organizations of the Treadway Commission (COSO) *Internal Control – Integrated Framework* (2013).

Subject	Consideration
<p>Boundaries of the reporting entity, accounting policies and estimates</p>	<p>The boundaries of the combined reporting entity tend to be less objective than those of a reporting entity that is legally bound together.</p> <p>Given that the combined/carved-out reporting entity is different from the larger reporting entity (if applicable), the accounting policies do not have to be the same. For example, it may be decided to revalue land and buildings in accordance with the revaluation model in IAS 16, whereas the larger reporting entity accounted for them on a cost basis. Furthermore, the ownership structure before and after a capital market transaction may have an impact on related party relationships and the estimation of certain accounts such as taxes.</p> <p>The process of determining the boundaries, the accounting policies and relevant estimates for the combined/carved-out reporting entity can be challenging and will involve judgement.</p>
<p>Internal controls</p>	<p>Management is responsible for the preparation and presentation of the combined and/or carve-out financial statements and it is expected that controls are designed and implemented in the financial reporting process for this purpose.</p> <p>It is important that these controls also cover the information technology environment for the preparation of the combined and/or carve-out financial statements.</p>
<p>Auditors' report</p>	<p>The format and wording of the auditors' report will be affected by whether the combined and/or carve-out financial statements are general-purpose or special-purpose financial statements.</p> <p>The respective applicability (i.e. general-purpose or special-purpose) can differ by jurisdiction and regulator. In addition, if local requirements related to the reporting exist, then they should be followed if the report is signed in accordance with these local requirements.</p>

Subject	Consideration
Materiality	<p>Auditors apply the concept of materiality in planning and performing an audit of financial statements.</p> <p>The materiality level for the audit of the combined/carved-out reporting entity may be set lower than the one used for the audit of the larger reporting entity. This could be due to the different users of the financial statements, the size of the entity and other qualitative factors – e.g. the nature of the transactions being more complex and higher risks identified.</p>
Management representation	<p>The independent auditor is required to obtain a written representation from management and, where appropriate, those charged with governance.</p>

Acknowledgements

This publication was made possible by the input of many people working in KPMG member firms worldwide.

We would like to acknowledge the efforts of the main contributors to this publication, as follows.

Robert de Boer	Netherlands
Holger Erchinger	US
Julie Santoro	US
Andrea Schriber	UK

We would also like to thank the following professionals from KPMG member firms who are on KPMG's global Working Group for their significant contributions to this edition of this publication.

Iain Alexander	UK
Jean Blascos	France
Elena Byalik	US
Jeri Calle	US
Jonathan Guthart	US
Ramon Jubels	Brazil
Gabriela Kegalj	Canada
Erhard Kühne	Germany
Paul Lau	Hong Kong
Maria Lee	Singapore
David Littleford	UK
Jesus Luna	Mexico
Claus Nielsen	Russia
Martin Pföhler	Germany
Luis Preciado	Mexico
Fred Versteeg	Netherlands
Katharine Wong	Hong Kong

Keeping in touch



Visit kpmg.com/ifrs for the latest on IFRS.

Whether you are new to IFRS or a current user, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as illustrative disclosures and checklists.

You can also follow our [LinkedIn showcase page](#) for the latest content and topical discussion.

Helping you deal with IFRS today...



Insights into IFRS

Helping you apply IFRS to real transactions and arrangements.

Guides to financial statements

Illustrative IFRS disclosures and checklists of currently effective requirements.



Newly effective standards



US GAAP

... and prepare for IFRS tomorrow



IFRS news



IFRS newsletters



IFRS for banks



IFRS 15 for sectors

Major new and forthcoming standards



Revenue



Financial instruments



Leases



Insurance contracts (under development)

Amendments to existing standards



Business combinations and consolidation



Presentation and disclosures



For access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG's Accounting Research Online. This web-based subscription service can be a valuable tool for anyone who wants to stay informed in today's dynamic environment. For a free 15-day trial, go to aro.kpmg.com and register today.

kpmg.com/ifrs

Publication name: *Combined and/or carve-out financial statements*

Publication number: 134329

Publication date: April 2017

© 2017 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

KPMG International Standards Group is part of KPMG IFRG Limited.

KPMG International Cooperative ("KPMG International") is a Swiss entity that serves as a coordinating entity for a network of independent firms operating under the KPMG name. KPMG International provides no audit or other client services. Such services are provided solely by member firms of KPMG International (including sublicensees and subsidiaries) in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners, or joint venturers. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any other member firm, nor does KPMG International have any such authority to obligate or bind KPMG International or any other member firm, in any manner whatsoever.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.