

HKFRS News

April 2008

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Carve-out/combined financial statements

IFRS provides very limited guidance on the preparation of carve-out/combined financial statements. This newsletter focuses on some commonly asked questions.

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

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

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

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

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

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

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

Most territories have no specific regulatory requirements for the preparation of combined financial statements. The most detailed and structured guidance available is that issued by the SEC with respect to US GAAP and the UK Annexure to the Standard for Investment Reporting ("SIR") 2000 for the presentation of financial information in an investment circular. Similarly in Hong Kong, the Auditing Guideline ("AG") 3.340 *Prospectuses and the Reporting Accountant* requires a combined basis accountants' report to be prepared for reorganisations under common control prior to issue of shares to the public.



HKFRS has converged with IFRS effective from 1 January 2005. Contents contained in this newsletter are relevant to both HKFRS preparers and IFRS preparers.

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

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

The same principle is applied consistently in all territories:

- Carve-out/combined financial statements present **historical** financial information prepared by aggregating the financial information of entities under common management and control, which did not form a legal group.
- Pro forma financial statements present **hypothetical** financial information created to present an illustration of how a capital market transaction might have affected an “issuer” of securities, had a specific transaction or series of transactions been undertaken at the commencement of the period being presented, or at the balance sheet date presented. In Hong Kong, the HKICPA issued HKSIR 300 *Accountants’ reports on pro forma financial information in investment circulars* and AG 7 *Preparation of pro forma financial information for inclusion in investment circulars*, which provide guidance to reporting accountants and preparers in dealing with pro forma financial information for inclusion in investment circulars.

Example

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

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

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

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

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

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

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

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

Example

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

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

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

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

Factors usually considered when doing the allocation include:

- Will the assets and liabilities be transferred to the carved-out group?
- Was there any intra-group recharge between the parent and the carved-out group (e.g. legal, accounting, finance expenses)? and
- Have the recharges been made on an arm’s length basis?

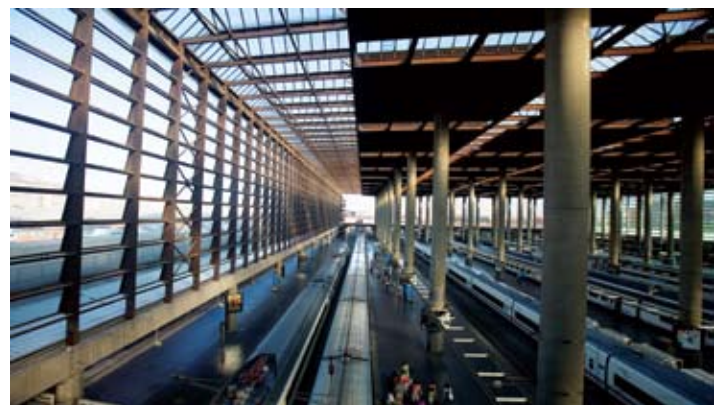
Allocations can only be made to the extent of the costs actually incurred by the larger group. That is, no allocation can be made on a “what if” basis. For example, allocation would not be made on the basis of estimating what the expenses of the carved-out business would have been if it had had its own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

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

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

How are income taxes dealt with?

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



How should debt and interest expense be allocated?

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

Example

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

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

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

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

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

The practical challenges vary depending on circumstances. Three key areas are highlighted below:

- The structure of the carved-out business:
Financial statements are easier to prepare when they are an aggregation of separate legal entities, each of which has their own stand-alone financial statements. Preparation of financial statements is more complex when it entails carving out portions of legal entities.
- The interaction between the carved-out/combined business and the rest of the group:
The extent of interaction will determine the complexity of identifying and reinstating intercompany transactions and allocating income, expenses, assets and liabilities. All of these relationships and transactions will likely be disclosed as those conducted between related party.
- The quality of the accounting records, internal controls, processes and systems:
The financial statements must be prepared reliably and must be auditable.

Contacts

For further help, please contact:

Hong Kong

22/F Prince's Building
Central, Hong Kong
Tel: +852 2289 8888

Beijing

26/F Office Tower A
Beijing Fortune Plaza
7 Dongsanhuan Zhong Road
Chaoyang District
Beijing 100020, PRC
Tel: +86 (10) 6533 8888

Shanghai

11/F PricewaterhouseCoopers Center
202 Hu Bin Road
Shanghai 200021, PRC
Tel: +86 (21) 6123 8888

Chongqing

Room 1905
19/F Metropolitan Tower
68 Zou Rong Road
Chongqing 400010, PRC
Tel: +86 (23) 6393 7888

Dalian

8/F Senmao Building
147 Zhongshan Road
Xigang District
Dalian 116011, PRC
Tel: +86 (411) 8379 1888

Guangzhou

25/F Center Plaza
161 Lin He Xi Road
Guangzhou 510620, PRC
Tel: +86 (20) 3819 2000

Macau

28/F Unit C
Bank of China Building
Avenida Doutor Mario Soares
Macau
Tel: +853 8799 5111

Qingdao

4601 Qingdao International Finance Center
59 Hong Kong Middle Road
Qingdao 266071, PRC
Tel: +86 (532) 8089 1888

Shenzhen

38/F Shun Hing Square
Di Wang Commercial Centre
5002 Shennan Road East
Shenzhen 518008, PRC
Tel: +86 (755) 8261 8888

Suzhou

Room 1501
Genway Tower
188 Wang Dun Road
Suzhou Industrial Park
Suzhou 215028, PRC
Tel: +86 (512) 6273 1888

Tianjin

17/F The Exchange Tower One
189 Nanjing Road, Heping District
Tianjin 300051, PRC
Tel: +86 (22) 2330 6789

Xi'an

Room 728
Zhongda International Mansion
30 Nan Da Street
Xi'an 710002, PRC
Tel: +86 (29) 8720 3336
<http://www.pwchk.com>
<http://www.pwc.com/ifrs>

