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Guidance Note on Combined and Carve-out Financial Statements



The Institute of Chartered Accountants of India
(Set up by an Act of the Parliament)
New Delhi

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Foreword

Financial Statements of an entity provides very significant information to various stakeholders about the entity. Depending on the size of an entity and the intricacies of its business, the financial statements could be a bit complex, particularly if the entity has several subsidiaries. An entity with a controlling interest in a subsidiary consolidates the financial statements of its subsidiary into its own financial statements. Consolidated financial statements aggregate the financial position of an entity and its subsidiaries. This allows an investor to overview the entity in a holistic manner rather than viewing the individual entity's financial statements separately. However, there may be events such as take-overs, demergers, spin-offs of entities and/or divisions/segments/businesses, initial public offerings, etc. where any specific financial information is required for part or parts of entities which may or may not be a part of an entity's group. In the case where there is absence of control, preparation of consolidated financial statements will not be appropriate. In such cases, as well as to present specific financial information, sometimes combined/carve-out financial statements are prepared for part or parts of one or more entities.

The preparation of combined financial statements is a challenging process that can require the exercise of considerable judgement. This Guidance Note is an endeavour to prescribe guidance for accounting in case of combined/carve-out financial statements and to assist in the preparation of combined/carve-out financial statements.

I would like to place on record my deep appreciation to CA. S.B. Zaware, Chairman, CA. M.P.Vijay Kumar, Vice-Chairman and other members of the Accounting Standards Board for their valuable contribution in the preparation of this Guidance Note.

I hope the concepts of combined/carve-out financial statements are understood and Guidance Note proves to be very useful.

New Delhi
January 11, 2017

CA. M. Devaraja Reddy
President

Preface

The Institute of Chartered Accountants of India through its Accounting Standards Board plays a proactive role by providing guidance on the various accounting issues raised from time to time. In this regard, it may be noted that SEBI constituted a 'Committee for Accounting Norms' for REITs and InvITs for examining and formulating the accounting and auditing norms for the listed REITs and InvITs. The Committee constituted various Sub-groups. One of the Sub-groups on 'Disclosures in Offer Document', submitted its report on disclosure of financial statements and other financial information in offer document which, *inter-alia*, requires the preparation of Combined Financial Statements in certain circumstances.

Since no guidance was available on the combined/carve-out financial statements in the Indian GAAP, the need for issuing guidance in this regard was felt. In this context, a general guidance on combined/carve-out financial statements was decided to be issued by ICAI, which was decided to be made applicable not only in the context of REITs/ and InvITs but to other transactions of specific nature also, such as, disposals, distributions, spin-offs, initial public offerings (IPOs), etc., where a specific type of financial information may be required. The financial information may be needed for part(s) of a group where the preparation of consolidated financial statements would not be appropriate. In such cases combined/carve-out financial statements are required to be prepared.

The Accounting Standards Board of the ICAI has decided to bring out this publication to guide the stakeholders regarding various aspects related to combined and carve-out financial statements. The Guidance Note deals with the meaning of combined/carve-out financial statements, indicative situations in which these may be required to be prepared, procedure for preparation of the same and required disclosures.

I would like to place on record special thanks to our Honourable President CA. M. Devaraja Reddy and Vice-President CA. Nilesh Vikamsey for providing an opportunity of bringing out this Guidance Note. I am also thankful to CA. M. P. Vijaykumar, Vice-Chairman, Accounting Standards Board for his support and efforts in all the endeavours of the Board. I would also like to thank members of Study Group for their efforts in preparing the Guidance Note, viz., CA. Anand Banka, CA. Anand

Subramanian, CA. Santosh Maller, CA. Sai Venkateshwaran, Mr. Akshay Bhandari, CA. K.Sairam and CA. Sudhir Soni Murlidhar. I would also like to thank members of the Accounting Standards Board for their valuable inputs in bringing out this Guidance Note.

I am confident that this Guidance Note would be useful to all concerned.

New Delhi
January 13, 2017

CA. S. B. Zaware
Chairman
Accounting Standards Board

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Guidance Note on Combined and Carve-out Financial Statements

Introduction

1. Generally, consolidated financial statements of an entity are required to be presented under the relevant legal or regulatory requirements. In India, these requirements are met by presenting consolidated financial statements prepared under the applicable Accounting Standards.
2. There may be occasions such as take-overs of entities and/or divisions/segments/businesses, demergers, spin-offs, initial public offerings, etc. where specific financial information is required for part or parts of entities which may or may not be part of a group. Similarly, group financials may be required for group loan arrangements. The term 'group', in such cases, for the purpose of this Guidance Note may include the entities and/or divisions/segments/businesses which are being combined as per the terms of the loan arrangement. In the absence of control, preparation of consolidated financial statements would not be appropriate. In such cases, as well as to present relevant combined financial information of part or parts of one or more entities, combined financial statements may be prepared. In certain circumstances, carve-out financial statements provide additional financial information for a part of an entity, such as, in case of demerger, spin-off, etc.
3. The combined/carve-out financial statements can include financial information pertaining to different entities, divisions, branches and/or an aggregation of similar assets, associated liabilities and operations in a specified geographic region or line of business pertaining to different entities. These financial statements can be prepared by aggregating financial statements of segments, separate entities or components of groups which may not necessarily have separate management and accounting records.
4. Combining businesses for which combined financial statements are prepared are generally under a common control of an entity, or a person; or the management; or they might be undertaking some common business. However, combined financial statements for

combining businesses can be prepared in other situations apart from these circumstances also.

5. Preparing combined/carve-out financial statements involve areas of judgement, driven by the purpose for which the statements are prepared.

Objective

6. This Guidance Note provides the meaning of combined/carve-out financial statements, indicative situations in which these may be required to be prepared and procedure for preparation of the same and required disclosures.

Scope

7. This Guidance Note applies in the preparation and presentation of combined/carve-out financial statements.
8. This Guidance Note should not be construed to be applicable to the general purpose financial statements as the combined/carve-out financial statements are prepared for specific purposes and, therefore, are 'special purpose financial statements'.

Definitions

9. The following terms are used in this Guidance Note with the meanings specified:

Carve-out business: For the purpose of this Guidance Note and notwithstanding the definition of 'business' as contained in Ind AS 103, *Business Combinations*, the term 'carve-out business' refers to an identifiable set of assets and liabilities, pertaining to an economic activity carved out of the aggregate activities of an entity. A division, segment, or business activity of an entity may also signify a carve-out business.

Carve-out Financial Statements: Carve-out financial statements are the financial statements pertaining to a carve-out business.

Combined Financial Statements: Combined financial statements are the financial statements that present the combined historical financial

information of combining businesses that do not comprise a group for which the consolidated financial statements can be prepared.

Combining businesses: For the purpose of this Guidance Note and notwithstanding the definition of 'business' as contained in Ind AS 103, *Business Combinations*, the term 'combining businesses' refers to two or more entities and/or divisions/segments/businesses of the same or different entities, historical financial informations in respect of which are being aggregated for the purpose of preparation of combined financial statements.

Common Control: Combining businesses are said to be under common control when all the combining entities are ultimately controlled by the same party or parties and that control is not transitory.

Financial Statements: For the purpose of this Guidance Note, combined/carve-out financial statements are the complete set of financial statements that are required to be prepared by the applicable Accounting Standards.

Remaining Group: Entities or part of entities other than the carve-out business in respect of which carve-out financial statements are prepared.

10. The terms used in this Guidance Note and not defined in this Guidance Note have the same meaning as those defined in the relevant Accounting Standards, and, in absence thereof, those defined in the Guidance Notes issued by the Institute of Chartered Accountants of India, unless the context requires otherwise.

Circumstances in which Combined/Carve-out Financial Statements may be prepared

11. Combined financial statements can be prepared in cases where:
 - a) two or more entities are combined in their entirety; or
 - b) two or more carve-out businesses of the same or different entities are combined; or
 - c) one or more entities are combined with one or more carve-out businesses.

12. Following are the examples where combined financial statements for combining businesses may be required to be prepared:
- a) transactions such as acquisition or disposition negotiations/agreement; for instance, a group of entities which do not form a group from a legal point of view, but are the subject matter of an acquisition or disposal;
 - b) filings in accordance with statutory or regulatory requirements, e.g., initial public offerings by Real Estate Investment Trusts, Infrastructure Investment Trusts etc.;
 - c) circumstances in which combined financial statements of commonly controlled entities are likely to be more meaningful than their separate financial statements. For example, combined financial statements would be useful if one or more individuals control several entities that are related/unrelated in their operations.
 - d) where two or more companies under the same group are required to prepare combined financial statements, for the purpose of borrowings from banks or other financial institutions, e.g., common loan arrangements.
13. Carve-out financial statements may be prepared for one or more divisions, segments, businesses, etc. of the same entity. Examples where carve-out financial statements may be required to be prepared are demerger, spin-off, hiving off or any other related restructuring of a segment/divisions/business of the same entity or acquisition of a segment/division/business of another entity.

Preparation of Combined Financial Statements

Procedure for preparation of combined financial statements for two or more entities

14. The guidance given in paragraphs 15 and 16 is applicable for preparation of combined financial statements for combining businesses of two or more entities in their entirety.

15. The procedure for preparing combined financial statements of the combining entities is the same as that for consolidated financial statements as per the applicable Accounting Standards. Accordingly, when combined financial statements are prepared, intra-group transactions and profits or losses should be eliminated, and non-controlling interests, foreign operations, different financial reporting periods, accounting policies or income taxes should be treated in the same manner as in consolidated financial statements prepared under the applicable Accounting Standards.
16. In case the combining entities or any one of the combining entities are under common control, the carrying amounts pertaining to a subsidiary, as reflected in the consolidated financial statements of the parent, should be used for the purpose of preparing combined financial statements.

Example: A Ltd. has three subsidiaries viz. X Ltd, Y Ltd. and Z Ltd. X Ltd. has better creditworthiness and approaches the bank for loan which will be used by both X Ltd. and Y Ltd. Bank requires combined financial statements of X Ltd. and Y Ltd. to be prepared for loan appraisal purposes. Combined financial statements of X Ltd. and Y Ltd. should be prepared using the amounts contained in A Ltd.'s consolidated financial statements pertaining to subsidiaries X Ltd. and Y Ltd.

Procedure for preparation of combined financial statements where at least one of the combining businesses is a carve-out business

17. Combined financial statements can be prepared reflecting aggregate historical financial information of two or more carve-out businesses of same or different entities; or one or more entities with one or more carve-out businesses.

Examples:

- A toll road project of company A Ltd. having various other projects is sought to be combined with a toll road project of another Company B; each of the companies has remaining projects which continue to operate independently.
- A toll road project of company A Ltd. having various other projects is sought to be combined with a wind-mill project of the

same company; remaining projects continue to operate independently.

- X. Ltd. which is a subsidiary of A. Ltd. is sought to be combined with a toll road project of A Ltd; remaining projects of A. Ltd continue to operate independently.
 - X. Ltd. which is a subsidiary of A. Ltd. is sought to be combined with toll road projects of A Ltd. and B Ltd; remaining projects of A Ltd. and B. Ltd continue to operate independently.
18. Financial statements prepared in such situations are combined financial statements irrespective of the fact that they involve one or more carve-out businesses as the combining businesses.
19. The procedure for preparing combined financial statements where at least one of the combining businesses is a carve-out business is as contained, hereinafter, in this Guidance Note. Thereafter, two or more combining businesses including carve-out businesses for which carve-out financial statements have been prepared are combined using the procedures similar to those for preparing consolidated financial statements as per the applicable Accounting Standards as explained in paragraphs 15 and 16 above.

Procedure for preparation of Carve-out Financial Statements

20. Where the information with regard to carve-out business is required, carve-out financial statements may have to be prepared. For preparing carve-out financial statements, difficulties in allocation may arise, for example, payroll accounting where a group of employees provides services for a particular carve-out business as well as for the remaining group, e.g., centralised purchasing, marketing, rent, advertising, legal, insurance, management expenses, etc.

Basis for allocating transaction amounts and balances

21. Where transactions or balances are not directly identifiable to the carve-out assets and liabilities and income and expenses pertaining to the concerned projects (collectively termed as 'carve-out business'), it will be desirable to develop methods for allocating the relevant amounts to the

carve-out business with a view to providing the fairest approximation to the amounts actually attributable to the carve-out business. An appropriate method can be adopted and applied for allocation purposes along with a disclosure of the basis adopted for allocation.

Example: Allocation of brand cost amongst various segments when only one segment is being carved-out while other segments also use the brand. In such case, brand cost may be allocated on an appropriate basis with disclosure of the basis adopted for allocation.

22. The appropriate basis for allocating common income and expenditure to a carve-out business will vary according to the circumstances. For instance, centrally accounted-for salaries and other related costs including retirement benefits may be allocated on the basis of headcount; however, relative levels of staff turnover or other factors also need consideration. Similarly, the costs of a head office accounts department may be allocated based on the relevant sizes of the carve-out business and remaining group. However, if other factors suggest that size is not a good basis, for example, a disproportionate number of the accounting team is engaged in work for one part of the business and not the other, any other basis might be considered appropriate for the purpose of allocation.
23. Assets may be allocated on the basis of control, usage, legal ownership or any other appropriate basis.
24. The basis of allocation of a group third party debt assumed by the carve-out business may be by reference to the terms of the separation agreement. In other cases, the debt may be treated as part of the carve-out business where the debt can be related to that business.
25. Finance lease liabilities may be allocated in line with the allocation of the related assets.
26. The allocation of the income and expenses generally move with the related assets and liabilities.

Example: The allocation of interest income and expenses would follow the way in which the related instruments have been apportioned.

27. The purpose of the allocation is to attribute an appropriate element to the carve-out business and not to measure and recognise income and expenses or assets and liabilities as if the carve-out business had always

been a standalone entity. Thus, the resulting financial position may not be that which might have existed if the carve-out business had been a stand-alone business.

Relationship with the remaining group

28. In addition to transactions with 'third parties', the results of the business may also include transactions with the remaining group.

Example: Sales which were previously regarded as 'intra-group' will need to be re-examined to determine whether they relate to entities within the carve-out business or outside it.

29. It is necessary to identify the extent of the relationships between the carve-out business and the remaining group. Balances with the remaining group may comprise elements of trading balances and short term or long term funding balances, which may or may not have been interest bearing. Balances of a trading nature will normally be presented as an element of debtors or creditors. Balances which are considered to be funding in nature (having regard, *inter alia*, to the use of the funds, the period for which they remain outstanding and the level of other funds) will normally be classified according to their general nature. Where the balance is interest bearing and/or has other characteristics of debt, it will be presented as debt financing. Where a balance does not have the characteristics of debt, it will be classified as capital and presented as a part of equity, aggregated with the owners' contribution (capital) and reserves of the carve-out business.

Example: Carve-out business was charged royalty on a periodic basis for the use of a product pertaining to an entity. From the perspective of carve-out financial statements, this fee stands payable to the owners since it is owed to the owners. It will be presented in the manner of debt financing in the carve-out financial statements since royalty is charged on a periodic basis and bears the characteristics of debt. However, in case no royalty is charged for the use of the product, then it will be treated as owner's contribution.

30. Balances with the remaining group may also contain elements of third party debtors or creditors which have been accounted for on behalf of the carve-out business by the remaining group.

Examples: VAT, payroll taxes, certain customers or suppliers common to the carve-out business and the remaining group, and external funding balances.

Such elements of the balances with the remaining group should be allocated appropriately.

Exceptional items

31. Exceptional items should be allocated to the carve-out business and accounted for in accordance with the applicable Accounting Standards.

Aspects common to Combined/Carve-out Financial Statements

Taxation

32. The determination of tax expenses in preparing carve-out/combined financial statements depends on whether the combining/carve-out businesses have filed separate tax returns or have their tax affairs dealt with as part of a larger tax entity. Generally, tax expenses should be determined for a combining/carve-out business as if the combining/carve-out business is a separate taxable entity.
33. The approach would involve the aggregation of the tax expenses actually incurred by the combining businesses (reflecting the benefits, reliefs and charges), after considering the tax effects of any adjustments. Where the information relating to the tax expenses actually incurred is not available, the tax expenses should be recomputed on the basis of the results of the combining business. Thus, if separate tax returns do not exist, a basis for allocating overall tax expenses must be determined on appropriate basis.

Impairment

34. For each period covered by the combined/carve-out financial statements, an independent assessment of the presence or absence of impairment indicators should be made based on the position post combination. Other provisions relating to measurement, recognition and disclosure of impairment should be governed by the applicable Accounting Standards.

Transaction costs

35. Transaction costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. Such costs should be recognised as expenses in the periods in which the costs are incurred and the services are received.
36. The costs to issue debt or equity securities should be recognised in accordance with the applicable Accounting Standards.

Capital

37. Where there is a legal capital, the same should be considered in preparing combined/ carve-out financial statements. However, it may not be possible to arrive at the amount of share capital pertaining to combining/carve-out businesses. In such cases, the difference between the assets and liabilities of the combining/ carve-out businesses, being net asset value, may be presented as capital. While doing so, to the extent balances (not having the characteristics of debt) treated as part of equity (see paragraph 29) should be considered as a component of the equity.

Cash flow statements

38. A cash flow statement is prepared in accordance with the applicable Accounting Standards.
39. Direct or indirect method may be adopted for preparation of cash flow statement depending upon the information available.

Disclosures

40. Disclosure is required in the notes to the combined/carve-out financial statements of the fact that the information presented may not be representative of the position which may prevail after the transaction. Similarly, the fact that resulting financial position may not be that which might have existed if the carve-out business/combining businesses had been a stand-alone business should also be disclosed.

41. Comparatives are not necessarily required to be given for the combined/carve-out financial statements.
42. The following should also be disclosed in the combined/carve-out financial statements apart from the disclosures specified in the other paragraphs:
 - a) the purpose of preparation of combined/carve-out financial statements;
 - b) a list of combining businesses together with brief description of activities;
 - c) statement of compliance with the applicable Accounting Standards;
 - d) the principal accounting policies followed in preparing the combined/carve-out financial statements;
 - e) the basis for allocation, critical assumptions, judgments, and estimates involved in the preparation of combined/ carve-out financial statements;
 - f) other disclosures as per the requirements of applicable Accounting Standards to the extent relevant;
 - g) where the accounting policies are not uniform in respect of the combining businesses, disclosure of that fact along with the accounting framework followed;
 - h) extent of balances (not having the characteristics of debt) treated as part of equity (refer paragraphs 29 & 37);
 - i) the basis of pricing inter-group transfers and any change therein.

The above disclosures are not exhaustive and specific disclosures that will assist users' understanding of combined/carve-out financial statements should also be made.

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