



Portfolio companies Acquisition to exit

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From acquisition to exit: Understanding the hurdles along the way

Private equity (PE) portfolio companies (PortCo's) face distinct and complex challenges throughout the life cycle of the PE's investment. From the PE's initial acquisition to eventual exit, a PortCo must navigate unique accounting and reporting issues while implementing operational improvements and strategic initiatives aimed at enhancing value. This Hot Topic discusses common accounting and financial reporting issues that a PortCo is likely to face during the life cycle of the PE's investment.

PEs typically use investment funds that may be considered investment companies for accounting purposes. This Hot Topic is not focused on the accounting for the investments at the PE fund level. See KPMG Handbook, [Investment companies](#), for further information about the accounting at the PE's investment fund level when the PE is considered an investment company.

For additional guidance on common and uncommon issues encountered by a PortCo over the life cycle of the PE's investment, also see the [Financial Statement Requirements in US Securities Offerings: What You Need to Know – 2025 Edition](#) (KPMG/Latham & Watkins) and these KPMG Handbooks:

[Business combinations](#)

[Derivatives and hedging](#)

[Debt and equity financing](#)

[Leases](#)

[Employee benefits](#)

[Share-based payment](#)

[SEC reporting for business combinations](#)

[Internal control over financial reporting](#)

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1 Initial acquisition

The beginning of a PortCo's life cycle is the PE's initial acquisition of a target company (Target) that will become the PortCo. Understanding the structure of the acquisition, legal entities involved and financial reporting requirements is critical to determining the appropriate accounting for the transaction.

This section focuses on common business combination issues at a PortCo. For a comprehensive discussion of the accounting for business combinations see KPMG Handbook, [Business combinations](#).

1.1 Transactions involving a newly formed entity (NewCo)

The formation of a new entity, often referred to as a 'NewCo', is a common practice in PE investments. A NewCo is typically created to facilitate the acquisition process and ensure that the transaction is structured to meet the strategic, tax and financial objectives of the PE investors.

In some cases, the NewCo will become the reporting entity for financial reporting and in other cases the financial reporting will continue at the Target level. If the NewCo is the reporting entity, PortCo management will need to determine if the NewCo is required to account for the acquisition of the Target as a business combination. If a business combination, the NewCo would record the Target's assets and liabilities at fair value (i.e. a step-up in basis).

If the reporting is at the legacy Target level, the PortCo will still need to evaluate whether there was a change of control (i.e. a business combination) at the NewCo or level above (e.g. the fund making the investment), in which case 'pushdown' accounting or a step-up in basis of the Target's assets and liabilities is optional. However, pushdown accounting is not allowed if no single investor or legal entity obtains control of the Target.

Observation

The legal entity structure for the PortCo and PE is often very complex. Obtaining an understanding of the overall structure and financial reporting requirements at each entity is important to understanding the effect of acquisition accounting on debt covenants and GAAP earnings. For example, a step-up in basis of the Target's assets could increase intangible amortization expense and reduce GAAP earnings per share.

1.1.10 Evaluating whether a NewCo is the acquirer

When a NewCo transfers cash or incurs liabilities to acquire a Target, the NewCo could be the accounting acquirer if it is deemed to be substantive. If the NewCo is substantive, it accounts for the acquisition of the Target as a business combination and records its net assets at fair value. The accounting

acquiree (Target) must be a business for the transaction to be a business combination, but it is not necessary that a NewCo accounting acquirer meet the definition of a business.

A non-substantive NewCo could indicate the transaction is not a business combination or that another entity (e.g. one of the combining entities) is the accounting acquirer. A NewCo formed solely to issue equity interests to effect a business combination between two preexisting operating entities is not the acquirer. However, in a typical PE transaction involving a single Target, the NewCo is not formed to facilitate the combination of two preexisting operating companies.

Determining whether a NewCo is substantive involves significant judgment due to the lack of authoritative guidance. Factors to consider in determining whether the NewCo is substantive include, but are not limited to:

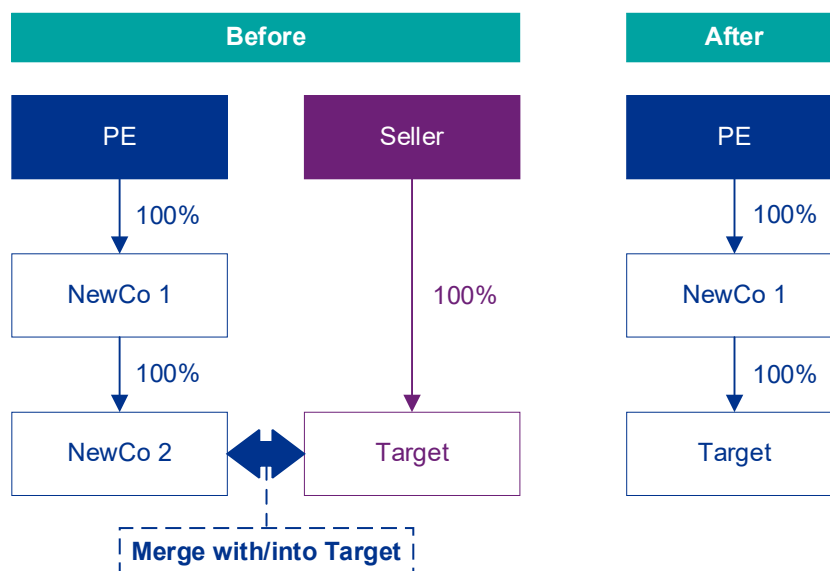
- whether the NewCo survives the transaction;
- whether the NewCo has assets other than cash related to the initial equity investment made by its founder;
- the pre-combination activities of the NewCo (e.g. raising capital, issuing debt, identifying a Target, negotiating, promoting the business combination);
- the governance of the NewCo and whether a new investor effectively obtained control of the acquiree;
- the reason the NewCo was used;
- how long the NewCo has been in existence; and
- whether the elements of the transaction are integrated or preconditioned on each other.

See section 4 of KPMG Handbook, [Business combinations](#), for an in-depth discussion for determining the accounting acquirer.

Example 1.1.10 Acquisition with NewCo

PE forms NewCo 1 to effect the acquisition of Target, which is a business. PE contributes cash into NewCo 1 and owns a 100% controlling interest. NewCo 1 then forms NewCo 2 and contributes the cash to NewCo 2.

NewCo 2 immediately transfers that cash for 100% of Target's shares and merges with Target. Target is the surviving entity in the merger with NewCo 2. The following diagram illustrates the legal entity structure before and after the transaction.



NewCo 1 is substantive for the following reasons.

- It has transferred cash.
- It survives the merger and is the reporting entity.
- The governance of NewCo 1 is different from Target and used by PE to obtain control of Target.

While NewCo 2 transferred cash, NewCo 2 is not substantive, and therefore cannot be the accounting acquirer, because it:

- was formed as a transitory entity only to effect the transaction;
- has no pre-combination activities; and
- does not survive.

NewCo 1 is the accounting acquirer and accounts for the acquisition of Target as a business combination. If Target prepares separate financial statements, it can elect to apply pushdown accounting. If pushdown accounting is not applied in Target's stand-alone financial statements, Target's assets and liabilities would remain at their historical cost basis.

1.2 Pushdown accounting

Pushdown accounting refers to establishing a new basis of accounting in the separate (often described as 'stand-alone') financial statements of the acquired entity (or Target). The acquirer's acquisition accounting adjustments are 'pushed down' to the Target's separate financial statements resulting in a step-up in basis by recording the Target's assets and liabilities at fair value. Push down accounting may be elected even if the acquirer did not apply acquisition accounting (e.g. if the acquirer was an individual or an investment company), in which case the Target (PortCo) would use the new basis that would have been created had the acquirer applied business combination guidance.

In pushdown accounting, the Target is considered a new reporting entity for accounting purposes. The retained earnings of the Target are eliminated and the

net effect of the pushdown adjustments is recognized as an adjustment to each of the affected capital accounts attributable to common shareholders.

While pushdown accounting typically results in the Target's assets and liabilities having the same basis in the Target's separate financial statements as in the acquirer's financial statements, the following are potential differences from the acquirer.

- **Transaction costs** incurred by the acquirer are not part of the new basis of the acquired entity. Therefore, the acquirer's transaction costs are not pushed down to the Target's separate financial statements.
- **Acquisition-related liabilities**, debt incurred by an acquirer and contingent consideration liabilities are only recognized in the Target's separate financial statements if required under other US GAAP (e.g. if the Target is a named obligor or if it meets the liability recognition requirements of joint and several liability arrangements).
- **A bargain purchase gain**, if any, recognized by the acquirer is not recorded in the Target's income statement. The Target recognizes a bargain purchase gain as an adjustment to additional paid-in capital in its separate financial statements.

See section 27 of KPMG Handbook, [Business combinations](#), for an in-depth discussion on pushdown accounting.

Observation

A PortCo is not required to apply pushdown accounting in its stand-alone financial statements, but if it is later transferred to another entity under common control of the PE firm, the receiving entity must record the PortCo's net assets at the PE firm's basis, including acquisition accounting adjustments. To avoid the complexity of retrospective valuations in such scenarios, PE firms should consider the potential for future common control transfers before electing not to apply pushdown accounting. See [section 5.3](#) for guidance on assessing common control relationships.

1.3 Predecessor/successor financial statements

When the NewCo is the reporting entity and subsequently decides to do an IPO, SEC rules typically require that the Target be considered the predecessor entity for reporting purposes primarily due to the NewCo having minimal historical operations. This results in the financial statements being presented on a 'blackline' or predecessor-successor basis (i.e. the Target's financials are presented on a historical basis for the period before the merger but include the effects of acquisition accounting adjustments post-merger). The presentation should include:

- the predecessor periods and successor periods separated by a blackline; and
- columns clearly labeled with either 'predecessor' or 'successor', or equivalent.

If the Target is the reporting entity and pushdown accounting is applied, the Target is required to present predecessor and successor financial statements separated by a blackline. See paragraphs 27.031 to 27.034a in KPMG Handbook, [Business combinations](#), for a discussion on presenting predecessor and successor financial statements including a discussion of the period in which to record contingent expenses.

1.4 Contingent consideration

Contingent consideration is usually an obligation of the acquirer to transfer additional consideration to the seller if specified future events occur or conditions are met. The acquisition of a PortCo often involves contingent consideration as a way to bridge the gap in valuation between buyers and sellers, finance the acquisition or incentivize ongoing management's performance. It is critical to understand how the contingent consideration is earned to properly account for the arrangement. Depending on the facts and circumstances the contingent consideration could be one of the following.

- **Additional purchase price.** The fair value of the consideration at the acquisition date is included in the purchase price and recorded as either an asset or a liability. The subsequent accounting depends on the consideration's classification as equity or a liability (asset).
 - Contingent consideration classified as equity is not remeasured after the acquisition date, and subsequent settlement is accounted for in equity.
 - Contingent consideration classified as a liability (or an asset) is remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value are recognized in earnings.
- **Compensation.** If the contingent consideration is compensatory in nature, the amounts are not purchase price and are a post-acquisition expense accounted for under the relevant compensation guidance, such as Topic 718 or 710.

1.4.10 Purchase price vs compensation

Whether arrangements for contingent payments to employees or selling shareholders are additional purchase price or compensation depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement, and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

When some or all of the selling shareholders become employees and any amount of the contingent consideration is forfeitable upon the employee terminating employment, the arrangement is compensation and not purchase price. While forfeiture upon termination of employment requires the arrangement to be classified as compensation, an entity must consider other indicators that could also lead to the arrangement being classified as compensation when not automatically forfeited. Those factors include (1)

duration of continuing employment, (2) level of compensation, (3) whether there are incremental payments to employees, (4) number of shares owned, (5) linkage to the valuation, (6) formula for determining the consideration and (7) other agreements with the selling shareholders.

See section 11 of KPMG Handbook, [Business combinations](#), for an in-depth discussion on evaluating contingent consideration arrangements and other compensation versus purchase price issues.

Observation

The PortCo should understand the accounting treatment for contingent consideration arrangements to consider the potential effects on GAAP earnings and related implications to its debt covenants and/or earnings per share in the event of an exit through an IPO.

2 Compensation arrangements

It is common for a PortCo to enter into new compensation arrangements with management to align management's interests with those of the PE owners. The compensation is often tied to exit events and could consist of share-based or cash payments. The arrangements are often complex, structured to be favorable from a tax perspective and require significant effort to determine the appropriate accounting.

This section focuses on common compensation related accounting issues at a PortCo. For a comprehensive discussion of the accounting for share-based payments or other employee benefits see KPMG Handbooks, [Share-based payment](#) and [Employee benefits](#).

2.1 Profits interests

A PortCo might grant compensation to employees using instruments that generally qualify as 'profits interests' for tax purposes. However, this term can be used to refer to various arrangements and/or take on a variety of legal forms. Given the variety of arrangements and different legal forms, a profits interest or similar award could be considered (1) a share-based payment arrangement accounted for under Topic 718, or (2) in substance, a bonus or profit-sharing arrangement accounted for under Topic 710.

For tax purposes, a profits interest unit is defined as a partnership interest other than a capital interest and the holder would receive no proceeds if the partnership were immediately liquidated at the time of receipt of the partnership interest. While the profits interest holder would not receive value in an immediate liquidation, the award has value to the holder due to the *upside* potential. In determining the fair value of a profits interest, it is inappropriate to

assume immediate liquidation of the interest. Instead, the valuation should be based on future cash flows to which profits interest holders will be entitled under the specified terms for cash distributions.

2.1.10 Analyzing profits interests under Topic 718

Topic 718 does not define a profits interest nor does it explicitly state whether awards of profits interests or similar instruments are in the scope of Topic 718. We believe the following are the key indicators that the entity is issuing shares or other equity instruments to employees that should be considered a share-based payment in the scope of Topic 718.

- The legal form of the profits interest or similar award is an equity unit of the entity.
- The arrangement provides the employee with rights associated with having an equity ownership interest in the entity, such as:
 - participation in fair value fluctuations of the entity (even if this is subject to senior classes of equity and a specified waterfall);
 - claims to the residual net assets of the entity upon dissolution or liquidation proportionate to other equity holders (and subordinate to debt holders and other creditors);
 - rights to the residual returns of the entity's net assets through distributions proportionate to the ownership interest.
- The employee either retains his or her rights to vested interests under the arrangement upon termination of service or the instrument is subject to repurchase at fair value.

The factors above are not all-inclusive or individually determinative and entities should consider all relevant information and apply judgment when determining whether a profits interest is in the scope of Topic 718. While we believe the profits interest must be legal form equity to be in the scope of Topic 718, other factors that indicate the award has characteristics of equity must also be present. In contrast, when legal form equity is not issued, the award could still be in the scope of Topic 718 if the entity incurs a liability for which the amount is based, at least in part, on the price of the entity's own shares. For example, a PortCo may grant phantom shares that are not legal form equity, but those shares entitle the grantee to an amount calculated by reference to other shares of the PortCo.

See [section 2.3](#) on accounting for awards in the scope of Topic 718 and [section 2.4](#) on accounting for awards outside the scope of Topic 718. See also section 1 of KPMG Handbook, [Share-based payment](#), for an in-depth discussion on evaluating profits interests awards.

Observation

Evaluating profits interest plans is very complex and involves evaluating provisions in multiple agreements. For example, PortCo management will often need to evaluate the grantee's award agreement, the overall share-based

payment plan and legal entity or stockholder agreements to understand all of the provisions affecting the award.

2.2 Awards issued by other legal entities

A PortCo often will have a complex legal structure involving many legal entities that sit between the reporting entity and the PE fund. These structures often exist for tax or other legal purposes. In some cases, another legal entity in the structure will grant share-based payments to the reporting entity's employees. Even though the shares being granted are not shares in the reporting entity itself, those arrangements will give rise to compensation expense at the reporting entity. However, depending on the nature and substance of the arrangement the accounting could be different, as follows.

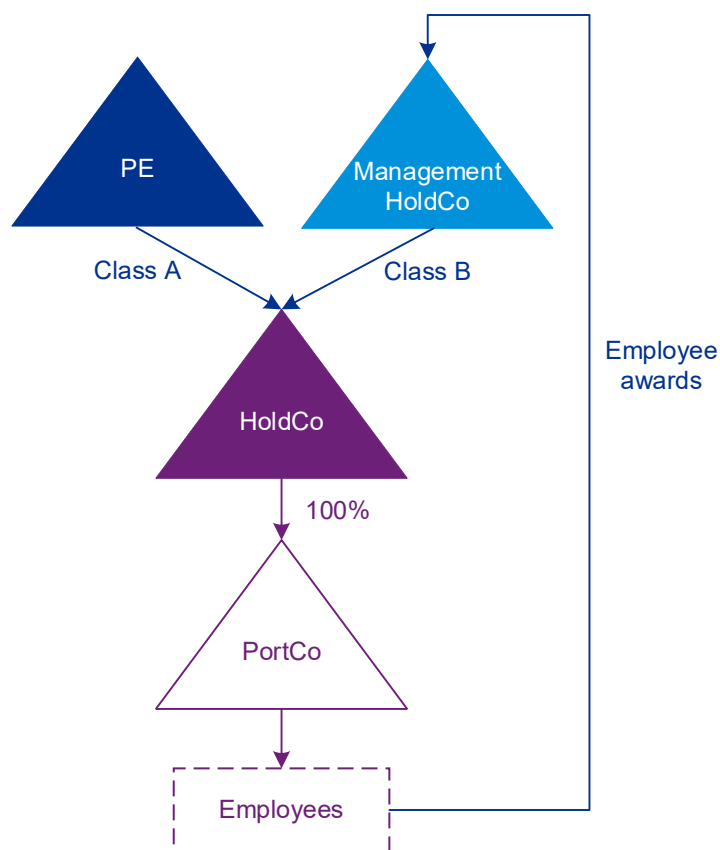
- **Downstream awards:** A parent entity that issues share-based payments to employees of a consolidated subsidiary is in the scope of Topic 718. In the subsidiary's stand-alone financial statements, the cost of the downstream awards is recognized at the same time and for the same amount as it is recognized by the parent entity with a corresponding credit to equity.
- **Sibling awards:** Share-based payments issued by one operating entity in a consolidated group to employees of another operating entity of the consolidated group (sibling awards) are not in the scope of Topic 718. These sibling awards are accounted for as compensation in the financial statements of the entity that is the grantee's employer. However, sibling awards may be measured and recognized similar to derivatives or in some cases similar to a downstream award.

See section 1 in KPMG Handbook, [Share-based payment](#), for an in-depth discussion of downstream and sibling awards.

In many cases, an entity will be formed solely for the purpose of issuing compensation to employees of the reporting entity and this upstream entity may not be a parent or a sibling entity as discussed above. The accounting for those arrangements is based on the substance of the arrangement, as the following Example illustrates.

Example 2.2.10 Awards granted in an upstream entity

PE forms HoldCo to acquire a controlling financial interest in PortCo. PortCo is the reporting entity post-acquisition. PE owns all of the Class A voting shares in HoldCo. PE also forms Management HoldCo (MHC) to issue shares for compensating PortCo's employees. MHC owns all the Class B shares in HoldCo and those shares are MHC's only assets. MHC shares are considered equity interests and economically provide holders with an equivalent interest in the Class B shares of HoldCo held by MHC. The following diagram summarizes the structure.



The awards of MHC shares granted to PortCo's employees are not considered downstream awards in form because MHC is not the parent of HoldCo. However, we believe they should be accounted for in a similar manner to downstream awards because MHC shares are economically equivalent to an equity interest in HoldCo (the parent) given the only assets MHC holds are the Class B shares in HoldCo and one MHC share represents an ownership of a Class B share of HoldCo. Therefore, the awards would be accounted for under Topic 718 and accounted for as a share-based payment in PortCo's financial statements similar to a downstream award.

Observation

The accounting function may have to proactively engage with other functions (tax, legal, HR, etc.) to identify awards granted by other legal entities because the legal agreements relate to an entity other than the reporting entity.

2.3 Accounting for share-based payments in the scope of Topic 718

For profits Interests or other share-based payment awards accounted for under Topic 718, equity-classified awards are measured at the grant-date fair value

and recognized as a cost over the employee's requisite service period. Liability-classified awards are recognized over the requisite service period but remeasured each period until ultimately settled. Nonpublic entities can make a policy decision to measure all liability-classified share-based payment arrangements either at fair value or at intrinsic value. Under either approach, the entity remeasures the liability-classified awards at each reporting date until settlement.

PortCo awards typically include vesting terms that align with the PE's exit strategy and return on investment. Those conditions could be based on time (service conditions). Alternatively, they could be based on achieving a metric based on the company's earnings or an exit event – e.g. a sale or IPO (performance conditions) or the PE owners achieving a specified rate of return or return on invested capital (market conditions). Understanding vesting conditions is critical to determining when the share-based payment expense is recognized.

2.3.10 Liability vs equity classification

Because the accounting treatment is different for an equity-classified award compared to a liability-classified award, classifying an award into one of these categories is crucial to determine the appropriate accounting for a share-based payment award.

The classification criteria require an evaluation of the award conditions, settlement features, the substantive terms of the award, and past practices of the grantor. The following are typical types of awards that require liability classification.

- **Cash-settled awards:** Awards required to be cash settled, awards for which the employee has the choice of cash settlement or awards for which the employer has a choice and does not have the intent or ability to settle in shares.
- **Other conditions:** Awards indexed to something other than a service, performance or market condition (i.e. an 'other condition').
- **Awards meeting criteria in Topic 480:** Awards that meet certain conditions in Topic 480. An entity must consider certain guidance in Topic 480 to determine whether a share-based payment award is liability-classified. For example, awards denominated in a fixed dollar amount and settled in a variable number of shares are liability-classified.
- **Underlying shares are liabilities:** Awards of options or other instruments whose underlying shares are required to be classified as liabilities.
- **Repurchase features:** Awards with repurchase features (i.e. callable or puttable shares) that allow the employee to avoid being (or for which it is probable the employer will prevent the employee from being) subject to the risks and rewards of ownership for a reasonable period of time (see below).

While PortCo awards could be liability-classified for any of the above reasons, a common feature in PortCo awards that needs to be evaluated is a repurchase feature.

Observation

The remeasurement of liability awards each period creates volatility in the PortCo's earnings. The PE should consider the implications of different features on the award's classification to evaluate the effect on debt covenants and GAAP earnings.

Repurchase features

Repurchase features could provide the employee the right to require the PortCo to repurchase shares for cash (puttable shares) or provide the PortCo the right to repurchase the shares from the employee for cash (callable shares). In some cases, those rights may be contingent on certain events occurring in the future. An award with repurchase features is liability-classified when either:

- the employee can avoid bearing the risks and rewards associated with share ownership for a reasonable period of time;
- it is probable the PortCo will prevent the employee from bearing risks and rewards of ownership for a reasonable period of time.

A reasonable period of time is considered six months or more from the point a vested share option is exercised or the vesting date for awards in shares. Shares repurchased prior to the six months of equity ownership are referred to as 'immature shares'. If the repurchase price is not fair value on the repurchase date, the six-month period may not be relevant because the grantee may not bear the risks and rewards of ownership.

A feature that is essentially a forfeiture provision in the form of a repurchase feature does not affect an award's classification. This situation would exist when the PortCo has the option to reacquire shares upon voluntary termination for an amount equal to the lower of a share option's original exercise price or fair value. The purpose of this repurchase feature is to permit the employee's holding period for tax purposes to begin at the grant date while requiring employment for a period of time to retain the award. As a result, in this situation the repurchase feature functions as a forfeiture (vesting) provision.

The analysis on awards with repurchase features can be complex, particularly when the rights are only exercisable on a contingent event. The evaluation includes understanding whether the repurchase price is at fair value, when the feature is exercisable, who controls whether the contingent event will occur, the probability of the event occurring, and (for call features) the entity's past practices and intent. For an in-depth discussion of repurchase features and their effect on classification, see section 3 of KPMG Handbook, [Share-based payment](#).

Example 2.3.10 Fair value call right contingent on termination

PortCo issues fully vested shares to employees subject to repurchase features included in PortCo's shareholder agreement. The shareholder agreement specifies that the shares may be repurchased within 90 days of the following

termination events and the call options do not expire on an IPO or change of control.

Nature of termination	Call price
Termination within two years	Lesser of cost or fair value
Termination after two years	Fair value

PortCo has a history and practice of exercising its repurchase rights even if the shares are not mature given the 90-day exercise window. PortCo evaluates the repurchase features as follows.

Termination within two years of grant date

The call feature triggered by termination within two years is in substance a forfeiture provision because the call price is the lower of cost or fair value. This call feature functions as a forfeiture provision and does not affect the classification of the award. However, it does affect the service period over which the award vests and compensation expense is recognized (i.e. cliff vesting over two years).

Termination after two years

Because this contingent call feature is at fair value, we believe there are two acceptable policies to evaluate this type of contingency.

- These rights only trigger liability-classification if it is probable, on an employee-by-employee basis, that the contingency will be triggered and the employer would exercise its right before the shares mature. Because the employer would call the shares within 90 days of termination, the evaluation would focus on whether it is probable that the employee will terminate in a timeframe such that the employer would repurchase immature shares.
- These rights always trigger liability-classification because the employer cannot prevent the employee from triggering the contingency and the employer would exercise its call right on immature shares. The awards would be liability-classified until the shares mature, at which time they would be reclassified to equity.

Depending on PortCo's policy, this repurchase feature may or may not require liability-classification. We understand it is common for PortCos to adopt the first policy and that liability-classification may not be required.

Example 2.3.20 Non-fair value call right contingent on termination

Assume the same facts as [Example 2.3.10](#), except that the call price is determined based on a formula price that is not fair value.

The award is liability-classified because the employee is not exposed to the risks and rewards of ownership and there is an expectation that the employer will exercise its right because the repurchase price is potentially below fair value. Therefore, it is probable the employer would prevent the employee from bearing the risks and rewards of ownership.

The employee is not exposed to the risks and rewards of ownership because the repurchase price is based on a formula and not fair value. Further, it is probable the employer would exercise its right because the price is potentially below fair value and termination is an event certain to occur. The probability assessment in [Example 2.3.10](#) is not relevant because the six-month holding period does not apply because the employee is never subject to the risks and rewards of ownership.

Observation

To avoid liability-classification, a PortCo often will structure its compensation arrangements so that the shares cannot be repurchased before they become mature using fair value at the repurchase date. It is also important to understand how fair value is determined in the award to make sure the award is consistent with fair value as contemplated in Topic 820 and not based on other metrics.

2.3.20 Vesting conditions

The period over which the compensation expense is recognized (called the employee's requisite service period) is determined by evaluating the vesting and exercisability conditions of the award. The award may have one or more of the following types of conditions: service, performance, market, or other conditions. Awards with other conditions are liability-classified awards as discussed in [section 2.3.10](#).

Condition	Example	Recognition period
Service: A requirement to remain employed for a period of time	Award vests after four years of service.	Recognizes expense over the explicit service period. The PortCo elects a policy to either estimate forfeitures or recognize forfeitures as incurred. No expense is recognized for awards that are forfeited.
Performance: A requirement to achieve an operating or financial target	Award vests if the entity achieves an EBITDA target over four years.	Recognizes expense over four years if probable of achieving the metric. If the metric is not achieved, no expense is recognized.
	Award vests on IPO or change of control (i.e. liquidity events).	Recognizes expense upon IPO or change of control; for accounting purposes those events are generally not considered probable until they occur.
Market: A requirement to achieve a specific measure of company's share price	Award becomes exercisable if investor achieves a certain internal rate of return (IRR).	Recognizes the expense over the explicit, implicit, or derived service period. If employee completes the service but the market condition is not achieved, the expense is still recognized.

Condition	Example	Recognition period
		Unlike a service or performance condition, the probability of achieving the condition is factored into the fair value of the award instead of whether the expense is recognized.

It is common for PortCo awards to vest with a combination of service, performance and/or market conditions resulting in multiple service or vesting periods. In that case, the employee requisite service period depends on whether the conditions are in an 'or' relationship or an 'and' relationship. The employee requisite service period is the shorter of the periods in an 'or' relationship (e.g. the award vests on satisfaction of four years of service or change of control). The employee requisite service period is the longer of the periods in an 'and' relationship (e.g. an award vests upon four years of service and an IPO).

Many PortCo awards vest based on achieving both performance and market conditions tied to the PE firm's exit strategy as discussed in the following Example.

Example 2.3.30 PortCo award that vests on performance and market condition

PortCo grants a targeted number of awards to management when a specified overall realized internal rate of return (IRR) and multiple of invested capital (MOIC) for the PE investors are achieved. The realized IRR and MOIC are measured on the occurrence of an IPO, a change in control, or the occurrence of sufficient proceeds from a special dividend (collectively, a 'Liquidity Event').

The IRR and MOIC are based on an overall return to PE investors and therefore are market conditions, similar to a total shareholder return measure. The probability of the specified overall IRR or MOIC being achieved will be incorporated into the grant-date fair value of the award and will not determine whether the compensation cost is recognized.

The Liquidity Event is a performance condition. The performance condition is not incorporated into the grant-date fair value measure. Instead, the probability the performance condition will be met is used to determine the attribution of the award. Because these Liquidity Events are not considered probable until they occur for accounting purposes, no compensation cost is recognized until the liquidity event occurs.

Assuming that all other conditions for equity classification are met, when the Liquidity Event occurs, compensation cost is recognized based on the grant-date fair value measure (which incorporates the market condition). For example, if the Liquidity Event occurs but the market condition is not met, the grant-date fair value of the award is still recognized as compensation cost because the performance condition is met.

Observation

When awards vest on a Liquidity Event (e.g. change in control or IPO) a PortCo does not recognize any compensation cost until that event occurs. Practically, if the award is liability-classified, a PortCo would not need to remeasure the award each period because no accounting entry is required. However, a PortCo should consider whether measurement is needed for disclosure purposes leading up to an IPO.

2.4 Accounting for a bonus or profit sharing

If a profits interest or other compensation plan is in substance a bonus or profit sharing plan (i.e. not a share-based payment in the scope of Topic 718), a PortCo typically accounts for these plans under other US GAAP such as Topic 710 as deferred compensation or Subtopic 450-20 as a contingency.

Under Topic 710, the compensation expense is recorded over the service period such that the present value of future payments is recognized at the full eligibility date (typically the vesting date). Similar to share-based payment awards, if the bonus or profit-sharing plan includes a performance condition, we believe an analogy to the share-based payment guidance is appropriate and a PortCo would only accrue compensation cost when it is probable that the payments will be made.

See chapter 3 of KPMG Handbook, [Employee benefits](#), for an in-depth discussion on the accounting for deferred compensation arrangements under Topic 710.

3 Initial public offering (IPO)

A common exit strategy for the PE is to take the PortCo public through an IPO. An IPO involves a number of accounting and reporting issues that require extensive effort for the PortCo. In addition, there is often a need to 'uplift' from private company financial statements to public-company compliant financial statements, including compliance with Sarbanes-Oxley (SOX) requirements. SOX 302/906, SOX 404(a), and SOX 404(b) require the now publicly traded PortCo to certify and disclose, following any applicable exemption period, that sufficient and effective internal controls are in place to ensure material information is recorded, processed, summarized and reported timely and accurately.

Observation

Preparing for a public offering will have a pervasive effect on a PortCo and will affect more than just accounting and reporting. Preparing for a public offering is a complex process that requires careful alignment of the PortCo's objectives with the sequencing of work effort and the PortCo's resources.

3.1 Financial statement requirements

Public securities offerings registered with the SEC under the US Securities Act of 1933 (the Securities Act) require the filing of a registration statement with the SEC and the distribution of a prospectus in connection with the offering. The registration statement and prospectus must contain certain financial statements and other financial information regarding the issuer's financial condition and results of operations. Financial statements of an entity filing the registration statement with the SEC must be accompanied by an auditor's report issued in accordance with the standards of the PCAOB.

The Securities Act and the related rules and regulations detail the disclosure requirements through the use of standard forms (e.g. Form S-1). These forms, in turn, specify the information that must be disclosed under Regulation S-K (S-K) and Regulation S-X (S-X). To simplify, S-K largely deals with textual disclosure and S-X with financial statement form and content.

At the core of these requirements are annual audited financial statements, which include balance sheets for the two most recent fiscal years and comprehensive income, cash flow and equity statements for the past three years (or the life of the issuer, if shorter). These must be accompanied by Management's Discussion & Analysis (MD&A) and an audit report from PCAOB-registered independent public accountants. Additionally, interim unaudited financial statements are required for the most recent stub period following the last audited balance sheet, along with comparative data from the prior year.

For companies involved in acquisitions, S-X Rules 3-05, 3-14 and Article 11 mandate that the financial statements of an acquired, or to be acquired, business be included in the issuer's required SEC filing(s), if the acquisition was significant to the issuer. This includes one or two years of the acquiree's audited financial statements and relevant interim data, along with pro forma financial information to reflect the effect of the acquisition, as necessary.

Special provisions apply to emerging growth companies (EGCs), which are allowed to present only two years of audited financial statements in their IPO filings and gradually phase into full compliance. EGCs also benefit from exemptions such as relief from SOX 404(b) auditor attestation requirements, although management's own assessment under SOX 404(a) remains mandatory. EGC status is lost upon exceeding revenue thresholds (> \$1.235B), reaching the five-year IPO anniversary, issuing significant debt (> \$1B), or becoming a large accelerated filer.

Special provisions also apply to smaller reporting companies (SRC). Entities should consult with SEC counsel about the determination of EGC or SRC status.

Observation

SEC registrants are required to prepare and report financial statements on an ongoing basis, these include annual reports on Form 10-K, quarterly reports on Form 10-Q and material information as it occurs periodically on Form 8-K. As a PortCo prepares for the offering, it should plan to have the appropriate

resources and processes in place to comply with the increased reporting responsibilities.

For additional considerations see [Financial Statement Requirements in US Securities Offerings: What You Need to Know – 2025 Edition](#) (KPMG/Latham & Watkins).

3.2 Private vs public considerations

While a PortCo is a private company, it may take advantage of private company accounting alternatives and practical expedients, and it typically has fewer disclosure requirements. However, as a PortCo plans a public exit, it will need to 'uplift' its financial statements to be public-company compliant (subject to EGC considerations above). This uplift process is critical for ensuring transparency and regulatory compliance in public filings like the S-1.

During the uplift process, private company alternatives adopted by a PortCo generally will need to be reversed unless there are specific transition requirements. Examples of private company alternatives and expedients that would need to be reversed relate to amortizing goodwill and subsuming customer relationships into goodwill (see section 26 of KPMG Handbook, [Business combinations](#)), using-risk free rates for lease discounting (see Question 5.6.06 in KPMG Handbook, [Leases](#)), and the simplified hedge accounting approach (see chapter 16 in KPMG Handbook, [Derivatives and hedging](#)). In contrast, the private company expedients related to share-based payment awards such as using intrinsic value for liability-classified awards have specific transition guidance upon becoming a public company (see paragraph 2.175 in KPMG Handbook, [Share-based payment](#)).

In addition to considering the effect of using private company accounting alternatives or expedients, a PortCo needs to consider the requirements it must adhere to once it becomes a public company, such as the S-X presentation standards and expanded US GAAP disclosure and presentation requirements (e.g. segment reporting and earnings per share). Public companies also have to comply with SEC accounting rules such as the temporary (mezzanine) equity guidance in ASR 268 (reproduced in Topic 480-10-S99-1) on presenting certain equity-classified instruments with redemption features outside of permanent equity (see chapter 7 of KPMG Handbook, [Debt and equity financing](#)).

Finally, effective dates for new accounting standards may differ for public and private entities, unless they qualify for EGC exemptions.

Observation

When determining whether a PortCo should elect any private company alternatives, PortCo management should consider the PE's exit strategy and likelihood of having to unwind the accounting for an IPO.

3.3 Internal controls

SOX compliance requires the PortCo to certify (SOX Sections 302/906) and disclose whether the entity has maintained:

- at the end of each quarter: effective disclosure controls and procedures, as defined in S-X Rules 13a-15(e) and 15d-15(e), to ensure that information required to be disclosed in the reports the entity files is recorded, processed, summarized and reported timely and accurately (S-K Item 307); and
- at the end of each annual period: effective internal control over financial reporting, as defined in S-X Rules 13a-15(f) and 15d-15(f), that provides reasonable assurance regarding the reliability of the entity's financial reporting and preparation of financial statements in accordance with GAAP, and includes policies and procedures pertaining to accurate books and records, authorization of cash receipts and expenditures, and safeguarding of assets (S-K Item 308).

Extensive effort is typically required by management, with participation of the CEO and CFO, under the oversight of the board of directors, to develop and implement financial reporting processes and controls and comply with the requirements for management's assessment of ICFR under SOX Section 404(a) and an independent auditor's attestation of the effectiveness of ICFR under SOX Section 404(b).

If the PortCo is an EGC, it is exempt for the first five fiscal years after it completes an IPO (or until EGC status is lost, if sooner) from the requirement to obtain an auditor's attestation of its ICFR under SOX Section 404(b). However, it is not exempt from management's certification under SOX Sections 302/906, which is required beginning with the first periodic filing after the IPO, and management's assessment of ICFR under SOX Section 404(a), which is required beginning with the second annual report on Form 10-K after the IPO.

According to a recent study, in 2024, 49% of all first-time management reports on ICFR under SOX Section 404(a) concluded that the entity's ICFR was not effective due to the existence of one or more material weaknesses, showing the challenges management may encounter in establishing an effective system of ICFR. A system like this requires that each of the five components of internal control: (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring, along with all relevant principles, be present and functioning. In addition, the five components must operate together in an integrated manner. Therefore, when preparing a PortCo for public-company readiness, a PortCo should take a holistic approach that spans several key areas.

From a business process perspective, it should assess and close gaps that could hinder timely and reliable public reporting. In terms of organization, talent and service delivery, a PortCo should reassess its structure, employment roles (including sufficiency of personnel with the necessary knowledge of GAAP and internal control requirements), and training programs to align with updated governance and compliance expectations. Leveraging outsourcing, offshoring or managed services can help address some of the resource gaps and support scalability. Meanwhile, management will likely need to enhance reporting

capabilities and explore automation and system integration to improve accuracy and timeliness.

Finally, governance must be revisited to ensure effective oversight of the system of internal control and overall compliance with public company requirements.

Observation

A PortCo's internal controls journey cannot be achieved alone and requires interaction, coordination and management among multiple internal and external parties. This requires proactively engaging with the audit committee, which provides oversight over the financial reporting process, and key internal parties in non-finance groups (IT, legal, sales, etc.) as well as establishing regular, consistent communications with key external parties (external auditors, SOX consultant, etc.).

3.4 Deferred issuance costs

A PortCo may incur significant costs getting ready for an IPO. The accounting for these costs depends on their nature. Specific incremental costs directly attributable to a shares offering are charged against the offering's proceeds. Such direct and incremental costs may include fees charged by underwriters, attorneys, accountants and printers.

In contrast, a PortCo records all internal costs, such as salaries and other general and administrative expenses, as current period expenses because these costs would have been incurred even without the share offering.

A PortCo may defer costs incurred before its issuance of shares if those costs are both direct and incremental. Specifically, direct, incremental costs incurred in the time leading up to a share offering may be recorded as an asset until the offering is complete, at which time the costs reduce the offering proceeds recorded in APIC. If the share offering is later aborted or withdrawn, these costs are expensed at that time. The costs related to a failed share offering cannot be deferred and charged against a later share offering. A short postponement period (up to 90 days) does not represent an aborted offering.

A PortCo may incur costs to re-audit prior-year financial statements in connection with the IPO. Even if the requirement to re-audit prior-year financial statements results directly from the registration process, the related costs are recorded as a current-period expense because they are not direct, incremental costs of issuing the shares.

For additional considerations see section 5.10 of KPMG Handbook, [Debt and equity financing](#).

4 Exit by sale

Another common exit strategy is for the PE to sell the PortCo to another PE firm or a corporate buyer. In a potential sale of a PortCo to an SEC registrant, it is important for a PortCo's management to understand the buyer's requirement to include the PortCo's historical financial statements in an SEC filing. If the PortCo does not have the required audited financial statements available, it could delay the transaction close.

S-X Rule 3-05 requires a registrant to provide separate audited annual and unaudited interim financial statements for a business that has been acquired or is probable to be acquired (such as a PortCo), if that business is deemed 'significant' to the registrant. If Rule 3-05 is triggered, the registrant must also file pro forma financial information under S-X Article 11.

Rule 3-05 applies when:

- a business combination has occurred or is probable (including equity method investments);
- the acquired entity meets significance tests; and
- the acquisition is not between entities under common control.

The significance tests are defined in S-X Rule 1-02(w) and include an investment test, asset test and income test. If any of these tests exceed 20%, financial statements of the Target are generally required. The number of years of financial statements depends on the level of significance.

- **20% to 40% significance:** The Target's audited financial statements for the most recent fiscal year, as well as unaudited financial statements for the subsequent interim period, are required. No comparative interim period financial statements are required.
- **Above 40% significance:** The Target's audited financial statements for the two most recent fiscal years, as well as the most recent unaudited interim period and the comparative interim period of the prior year, are required.

These Rule 3-05 financial statements need to comply with Reg S-X and US GAAP requirements for a public business entity (PBE). An entity whose financial statements or financial information is required to be included (or is voluntarily included) in a filing with the SEC is considered a PBE under the FASB's definition and therefore its financial statements:

- may not use Private Company Council (PCC) accounting alternatives (e.g. amortization of goodwill); and
- must apply public company transition provisions for new standards except in certain circumstances (e.g. an entity is an EGC). For example, the SEC provided relief on the required timing of adoption of the revenue and leases accounting standards for companies that only met the definition of a PBE because their financial statements are included in a registrant's filing (e.g. under Rule 3-05).

The financial statements would be presented as if the company had always been public, unless the SEC staff has issued specific guidance to the contrary. If the acquired business's historical interim and annual financial statements

were not prepared on that basis, they must be retrospectively revised for purposes of inclusion in the filing.

Notwithstanding the definition of a PBE, certain information and disclosures required by various accounting standards are not required for nonpublic acquired businesses or acquired businesses that do not have publicly held common stock or potential common stock (e.g. initial public offering). Each of these standards included its own definition of public entity before the FASB adopted the definition of public business entity, which applies to standards issued by the FASB after December 2013. Disclosures not required to be provided in a nonpublic acquired business's financial statements include, but are not limited to, disclosures that would otherwise be required by:

- Topic 260 (earnings per share) (paragraph 260-10-05-1);
- Topic 280 (segment reporting) (paragraph 280-10-15-3); and
- Topic 715 (retirement benefits) (paragraph 715-20-50-5).

Observation

Under S-X Rule 3-05, the type of audit opinion required for financial statements of an acquired or to be acquired business depends on the status (private versus public) of the acquiree and the context of the filing. Generally, audits under AICPA standards are acceptable. However, if the PortCo is identified as a predecessor of the SEC registrant, the audit must be performed under PCAOB standards.

5 Other issues

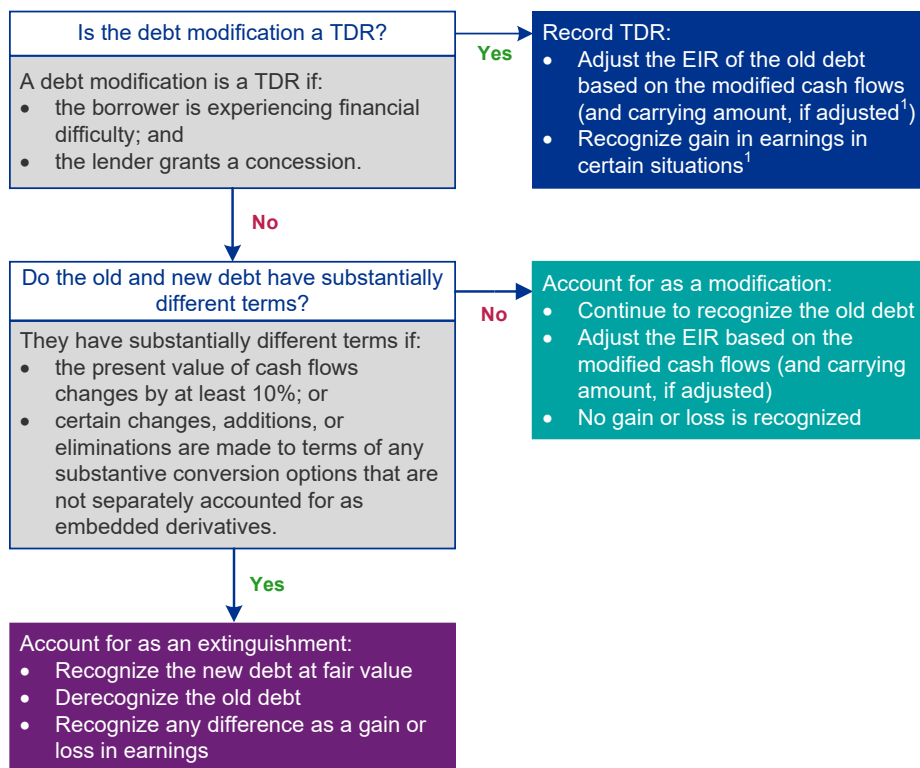
A PortCo may be involved with a number of other complex transactions throughout its life cycle. Below are common transactions that a PortCo may be involved with while under PE ownership.

5.1 Debt restructuring

A PortCo is often capitalized with a significant amount of debt raised as part of the acquisition. As a result, it may restructure its debt for a number of reasons such as obtaining better interest rates or taking on more leverage to pay a dividend to shareholders. It also may restructure its debt when the debt obligations become unsustainable or misaligned with its (or the PE's) financial performance or strategic goals.

If the PortCo issues new debt to a new lender to repay existing debt from a different lender, the accounting may be relatively straightforward and the PortCo would apply extinguishment accounting to the debt being repaid and account for the new debt under Topic 470. However, when the debt restructuring involves a modification or exchange of existing debt with the same lenders or some portion of the same lenders, the accounting for a debt restructuring depends on a number of factors and could be considered a

troubled debt restructuring (TDR), modification or extinguishment depending on the facts and circumstance as illustrated in the following decision tree.



Note:

1. If the carrying amount of the old debt is greater than the undiscounted cash flows of the restructured debt, the carrying amount is adjusted to those undiscounted cash flows. This results in an EIR of zero and recognition of a gain.

The accounting analysis for a debt restructuring and any related fees or costs can be complex with significant accounting and disclosure consequences. For additional considerations see chapter 4 of KPMG Handbook, [Debt and equity financing](#).

5.2 Recapitalization

A recapitalization transaction is a type of corporate restructuring that alters a PortCo's capital structure, typically by changing the mix of debt and equity. These transactions are often used to stabilize a PortCo's balance sheet, return capital to shareholders or prepare for strategic events like acquisitions, divestitures or ownership transitions.

If the recapitalization results in a new entity obtaining control of the PortCo, the new controlling investor accounts for the transaction as a business combination (assuming the PortCo meets the definition of a business). At the PortCo level, the change of control gives the PortCo the option to apply pushdown accounting (see [section 1.2](#)).

If the PortCo does not elect pushdown accounting (or there is no change of control), there is no step-up in basis in the PortCo's financial statements. The only accounting for the transaction relates to the debt or equity issuances, repurchases or restructurings. Any fees incurred as part of the transaction are accounted for according to their nature as either debt issuance costs, a reduction of equity or expense for certain other advisory costs (see [section 3.4](#) regarding equity issuance costs). Due to the related party nature of these transactions, it is critical to identify all the elements of the transaction to account for those elements under the appropriate guidance, especially if the debt or equity transaction is not at fair value.

Example 5.2.10 Recapitalization

PortCo, which meets the definition of a business, is owned by PE firms A, B, C and D. A owns 40%, B owns 30%, C owns 20%, and D owns 10%. None of the entities has a controlling financial interest in PortCo.

PortCo subsequently raises new debt and uses the funds to buy back all of B's shares. As a result, A's ownership increases to 57% and it now has a controlling financial interest. PortCo could elect to apply pushdown accounting in its separate financial statements. If it does not elect pushdown accounting, PortCo only has to account for the debt issuance under Topic 470 and its repurchase of equity under Topic 505.

In contrast, if PortCo buys back D's shares and A's ownership only increases to 44% without obtaining a controlling financial interest, a business combination has not occurred. In that situation, pushdown accounting is prohibited and PortCo only has to account for the debt issuance under Topic 470 and its repurchase of equity under Topic 505.

5.3 Put-together of PortCos

A PE may decide to combine two or more of its PortCos to maximize value and create synergies. The accounting for the put-together transaction will depend on whether the PortCos are under common control.

A transaction qualifies as a combination of entities under common control only if all of the combining entities are under common control before and after the combination. Two or more entities may be deemed to be under common control when they are subject to control by the same parent, investor or ownership group that has agreed to vote in concert. As used here, control has the same meaning as used in the FASB's guidance on consolidation, which considers both the variable interest and voting interest model.

A PE firm may sponsor and manage multiple funds, but when viewed through the lens of Topic 810 on consolidation, the PE firm may not have a controlling financial interest in the funds. Further, there may not be another single entity or party that controls each of the funds. In that case, when PortCos from different funds are combined, they would not be considered to be under common control.

If the transaction is a combination of entities under common control, it is not a business combination and the receiving entity records the net assets of the transferred entities at the ultimate parent's (e.g. the PE fund's) basis. In that case, the entities would be combined at their carrying amounts unless the parent's basis differs from the transferred entities' basis because, for example, the transferred entities did not apply pushdown accounting. See section 28 of KPMG Handbook, [Business combinations](#), for in-depth discussion on the accounting for common control transactions.

If the PortCos are not under common control, the transaction is a business combination and one of the combining entities is the acquirer and the others are the acquiree(s). The acquiree(s) would be recorded at fair value in the acquirer's financial statements. See section 4 of KPMG Handbook, [Business combinations](#), on identifying the accounting acquirer.

Observation

PE fund ownership structures are often very complex. Evaluating whether PortCos are under common control may require a detailed analysis of the ownership of each of the PE funds to determine if there is a single entity or individual (e.g. a founder) that ultimately controls each of the funds and the PortCos. Making this determination may involve engaging internal parties in non-finance groups (tax, legal, etc.).

5.4 Continuation funds

PE continuation funds are investment vehicles created to provide liquidity to limited partners in an existing fund and extend investment horizons for an existing PortCo. These funds are typically used when the original investment fund is approaching the end of its term, allowing the general partner to continue managing certain assets that may require more time to reach their full potential. By transferring these assets into a continuation fund, the original investors can choose to cash out or reinvest, while new investors can participate in the fund.

Similar to the discussion above on put-together transactions, the accounting would be dependent on whether the existing fund and continuation fund are considered to be under common control. If the funds are not under common control, the PortCo would need to go through an analysis similar to that described above with the initial acquisition to determine if there is a business combination that needs to be recorded by the reporting entity or whether there is a change of control above the reporting entity such that the PortCo could elect pushdown accounting.

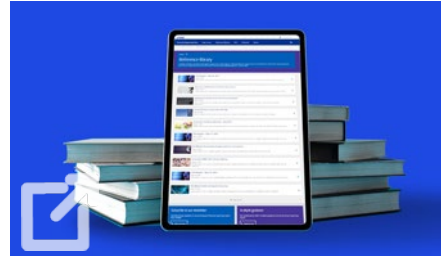
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