

Combined financial statements of Combat Propulsion System
a Business of L3Harris Technologies, Inc. (prepared in accordance with US GAAP) as of and for the fiscal years ended January 1, 2021 and January 3, 2020



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Report of Independent Auditors

To Management of L3Harris Technologies, Inc.

We have audited the accompanying combined financial statements of Combat Propulsion Systems, a business of L3Harris Technologies, Inc., which comprise the combined balance sheets as of January 1, 2021 and January 3, 2020, and the related combined statements of income, comprehensive income, changes in parent's equity and cash flows for the years then ended, and the related notes to the combined financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of Combat Propulsion Systems at January 1, 2021 and January 3, 2020, and the combined results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

May 28, 2021

COMBAT PROPULSION SYSTEMS
A BUSINESS OF L3HARRIS TECHNOLOGIES, INC.
COMBINED STATEMENT OF INCOME

	Fiscal Years Ended	
	2020	2019
	(In thousands)	
Revenue from product sales and services	\$ 236,433	\$ 182,716
Cost of product sales and services	146,433	111,454
Engineering, selling and administrative expenses	31,375	26,059
Non-operating income	4,252	1,794
Income before income taxes	62,877	46,997
Income taxes	16,218	10,248
Net income	\$ 46,659	\$ 36,749

See accompanying Notes to Combined Financial Statements.

COMBAT PROPULSION SYSTEMS
A BUSINESS OF L3HARRIS TECHNOLOGIES, INC.
COMBINED STATEMENT OF COMPREHENSIVE INCOME

	Fiscal Years Ended	
	2020	2019
	(In thousands)	
Net income	\$ 46,659	\$ 36,749
Other comprehensive (loss) income:		
Foreign currency translation gain (loss), net of income taxes	970	(184)
Total comprehensive income	\$ 47,629	\$ 36,565

See accompanying Notes to Combined Financial Statements.

COMBAT PROPULSION SYSTEMS
A BUSINESS OF L3HARRIS TECHNOLOGIES, INC.
COMBINED BALANCE SHEET

	Fiscal Years Ended	
	2020	2019
	(In thousands)	
Assets		
Current Assets		
Cash	\$ 7,939	\$ 6,292
Receivables	33,767	13,019
Contract assets	39,523	51,317
Inventories	5,591	8,672
Other current assets	289	152
Total current assets	87,109	79,452
Non-current Assets		
Property, plant and equipment	23,818	26,845
Operating lease right-of-use assets	2,972	2,995
Goodwill	127,548	127,548
Other intangible assets	514	729
Deferred income taxes	2,787	2,748
Total non-current assets	157,639	160,865
	\$ 244,748	\$ 240,317
Liabilities and Equity		
Current Liabilities		
Accounts payable	\$ 16,539	\$ 17,101
Contract liabilities	5,782	1,454
Compensation and benefits	3,218	3,318
Other accrued items	875	1,258
Total current liabilities	26,414	23,131
Non-current Liabilities		
Operating lease liabilities	2,672	2,726
Deferred income taxes	27,646	26,862
Other long-term liabilities	403	418
Total non-current liabilities	30,721	30,006
Parent's Equity		
Net parent investment	187,364	187,901
Accumulated other comprehensive income (loss)	249	(721)
Total parent's equity	187,613	187,180
	\$ 244,748	\$ 240,317

See accompanying Notes to Combined Financial Statements.

COMBAT PROPULSION SYSTEMS
A BUSINESS OF L3HARRIS TECHNOLOGIES, INC.
COMBINED STATEMENT OF CASH FLOWS

	Fiscal Years Ended	
	2020	2019
	(In thousands)	
Operating Activities		
Net income	\$ 46,659	\$ 36,749
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and other amortization	4,168	4,921
Share-based compensation	175	372
Pension and other postretirement benefit plan income	(3,141)	(917)
Loss on disposal of property, plant and equipment	3,267	6
Deferred income taxes	991	2,496
(Increase) decrease in:		
Accounts receivable	(20,488)	(5,315)
Contract assets	11,981	9,625
Inventories	3,199	(710)
Increase (decrease) in:		
Accounts payable	(1,242)	3,756
Contract liabilities	4,315	(3,231)
Compensation and benefits	(173)	(2,640)
Other accrued items	(430)	(1,793)
Other	(153)	1,567
Net cash provided by operating activities	49,128	44,886
Investing Activities		
Additions to property, plant and equipment	(3,497)	(1,185)
Net cash used in investing activities	(3,497)	(1,185)
Financing Activities		
Net transfers to parent	(44,568)	(42,365)
Net cash used in financing activities	(44,568)	(42,365)
Effect of exchange rate changes on cash	584	(96)
Net increase in cash	1,647	1,240
Cash, beginning of period	6,292	5,052
Cash, end of period	\$ 7,939	\$ 6,292

See accompanying Notes to Combined Financial Statements.

COMBAT PROPULSION SYSTEMS
A BUSINESS OF L3HARRIS TECHNOLOGIES, INC.
COMBINED STATEMENT OF PARENT'S EQUITY

	Net Parent Investment	Accumulated Other Comprehensive Income	Total Parent's Equity
	(In thousands)		
Balance at December 28, 2018	\$ 194,006	\$ (537)	\$ 193,469
Net income	36,749	-	36,749
Other comprehensive (loss) income	-	(184)	(184)
Net transfers to parent	(42,854)	-	(42,854)
Balance at January 3, 2020	187,901	(721)	187,180
Net income	46,659	-	46,659
Other comprehensive (loss) income	-	970	970
Net transfers to parent	(47,196)	-	(47,196)
Balance at January 1, 2021	\$ 187,364	\$ 249	\$ 187,613

See accompanying Notes to Combined Financial Statements.

COMBAT PROPULSION SYSTEMS
A BUSINESS OF L3HARRIS TECHNOLOGIES, INC.
NOTES TO COMBINED FINANCIAL STATEMENTS
(Dollars in thousands, unless otherwise noted)

NOTE 1: BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization — Combat Propulsion Systems (or “CPS”, the “Business”, “We” or “Our”) is a carve-out business within the Aviation Systems reportable segment of L3Harris Technologies, Inc. (“L3Harris” or “Parent”), an agile global aerospace and defense technology innovator, delivering end-to-end solutions that meet customers’ mission-critical needs. CPS is a market leader in the engineering, design, manufacture and remanufacture of engines, transmissions, suspensions and turret drive systems for tracked and wheeled combat vehicle systems. Our principal operations are based out of Muskegon, Michigan in the United States and we also operate a satellite office in Starnberg, Germany where our Magnet-Motor business is located.

On June 29, 2019, L3Harris Technologies, Inc. (formerly Harris Corporation) completed a merger with L3 Technologies, Inc. (the “L3Harris Merger”). Prior to the L3Harris Merger, CPS was a wholly owned business of L3 Technologies, Inc. (“L3”). Although L3Harris accounted for the L3Harris Merger under the acquisition method of accounting, pushdown accounting was not applied in the accompanying Combined Financial Statements or these Notes. Pushdown accounting has been applied for historical acquisitions of L3 Technologies, Inc. prior to the L3Harris merger.

Description of the Transaction — On March 1, 2021, L3Harris announced that it had reached a definitive agreement with RENK AG (the “Sale Agreement” or the “Transaction”) under which RENK AG will acquire CPS for \$397.9 million before adjustments in respect to net cash and other items. The Transaction is subject to customary closing conditions, including regulatory approval, and is expected to close in the second half of 2021. In anticipation of the Transaction, the accompanying Combined Financial Statements have been prepared for CPS.

Basis of Presentation — Our Combined Financial Statements and these Notes to Combined Financial Statements (these “Notes”) were derived from the consolidated financial statements and accounting records of L3, for the six months ending June 28, 2019, and of L3Harris, for the six months ended January 3, 2020 and fiscal year ended January 1, 2021, as if the Business were operated on a standalone basis during the periods presented, and were prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”).

The accompanying Combined Financial Statements are not necessarily indicative of the financial position, results of operations or cash flows that would have been achieved if the Business had operated as a separate, standalone entity as of or during any of the periods presented, nor are they indicative of the financial position or results going forward due to the changes in the business.

Our Combined Balance Sheet includes the assets and liabilities of CPS. L3Harris uses a centralized approach to cash management and financing of its operations in various jurisdictions. The cash of CPS’s U.S. entity is transferred to a L3Harris corporate bank account daily and L3Harris funds CPS’s working capital and capital expenditure requirements as needed. The cash of CPS’s U.S. entity transferred to L3Harris has been excluded from these Combined Financial Statements. Although employees of the Business may participate in one or more defined benefit plans sponsored by L3Harris and the Business is allocated a proportionate share of the associated net periodic benefit income, L3Harris is retaining the defined benefit plan obligations and therefore no portion of plan assets or benefit obligations has been allocated to the Business. Net parent investment represents L3Harris’s interest in the recorded net assets of CPS. Assets and liabilities for amounts due to or due from CPS and L3Harris are included in the “Net parent investment” line item in our Combined Balance Sheet.

CPS receives services and support from various functions performed by L3Harris and CPS’ operations have been dependent upon L3Harris’s ability to perform these services and support functions. Shared corporate functions include, but are not limited to, executive and segment oversight, finance, legal, human resources and information

technology (“IT”). With the exception of IT costs, the costs of shared corporate and segment functions are primarily allocated based on a three-factor formula that considers the Business’ revenue, headcount and fixed assets relative to L3Harris’ consolidated revenue, headcount and fixed assets. IT costs have been allocated based on headcount. Where costs have been allocated to the Business, such allocations are considered to represent a reasonable reflection of the utilization of services by, or benefit provided to, CPS, and we believe the accompanying Combined Financial Statements include all costs of doing business. However, the allocations may not be indicative of the actual expense that would have been incurred had CPS operated as an independent, stand-alone entity. See *Note 14: Related Party Transactions* in these Notes for additional information regarding corporate and segment level costs included in the accompanying Combined Financial Statements.

Use of Estimates — The preparation of financial statements in accordance with U.S. GAAP requires us to make estimates and assumptions that affect the amounts reported in the accompanying Combined Financial Statements and these Notes. These estimates and assumptions are based on experience and other information available prior to issuance of the accompanying Combined Financial Statements and these Notes. Materially different results can occur as circumstances change and additional information becomes known.

Fiscal Year — Our fiscal year ends on the Friday nearest December 31.

Cash — Cash includes amounts in our non-U.S. bank accounts, which are not swept as part of L3Harris’ centralized cash pooling program.

Fair Value of Financial Instruments — The carrying amounts reflected in our Combined Balance Sheet for cash, accounts receivable and accounts payable approximate their fair values.

Fair Value Measurements — Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal market (or most advantageous market, in the absence of a principal market) for the asset or liability in an orderly transaction between market participants at the measurement date. Entities are required to maximize the use of observable inputs and minimize the use of unobservable inputs in measuring fair value, and to utilize a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. The three levels of inputs used to measure fair value are as follows:

- Level 1 — Quoted prices in active markets for identical assets or liabilities.
- Level 2 — Observable inputs other than quoted prices included within Level 1, including quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; and inputs other than quoted prices that are observable or are derived principally from, or corroborated by, observable market data by correlation or other means.
- Level 3 — Unobservable inputs that are supported by little or no market activity, are significant to the fair value of the assets or liabilities, and reflect our own assumptions about the assumptions market participants would use in pricing the asset or liability developed using the best information available in the circumstances.

Accounts Receivable — We record receivables at net realizable value and they generally do not bear interest. In evaluating the allowance for estimated uncollectible accounts to reflect any loss anticipated on the accounts receivable balances, we consider historical write-offs by customer, level of past due accounts and economic status of the customers. A receivable is considered delinquent if it is unpaid after the term of the related invoice has expired. To the extent we have write-offs, those write-offs are recorded at the time a customer receivable is deemed uncollectible. We did not have any write-offs in fiscal 2021 or 2020 and our allowance for estimated uncollectible accounts is \$0 as of January 1, 2021 and January 3, 2020.

Contract Assets and Liabilities — The timing of revenue recognition, customer billings and cash collections results in accounts receivable, contract assets and contract liabilities at the end of each reporting period. Contract assets include unbilled amounts typically resulting from revenue recognized exceeding amounts billed to customers for contracts utilizing the percentage of completion (“POC”) cost-to-cost revenue recognition method. We bill customers as work progresses in accordance with agreed-upon contractual terms, either at periodic intervals, upon achievement of contractual milestones or upon deliveries and, in certain arrangements, the customer may withhold payment of a small portion of the contract price until contract completion. Contract liabilities include

advance payments and billings in excess of revenue recognized, including deferred revenue. Contract assets and liabilities are reported on a contract-by-contract basis at the end of each reporting period. There were no noncurrent contract liabilities.

Contract assets related to amounts withheld by customers until contract completion are not considered a significant financing component of our contracts because the intent is to protect the customers from our failure to satisfactorily complete our performance obligations. Payments received from customers in advance of revenue recognition are not considered a significant financing component of our contracts because they are utilized to pay for contract costs within a one-year period or are requested by us to ensure the customers meet their payment obligations. See *Note 3: Contract Assets and Contract Liabilities* in these Notes for additional information.

Inventories — Inventories are valued at the lower of cost (determined by average and first-in, first-out methods) or net realizable value. We regularly review inventory quantities on hand and record a provision for excess and obsolete inventory primarily based on our estimated forecast of product demand, anticipated end of product life and production requirements. See *Note 4: Inventories* in these Notes for additional information regarding inventories.

Costs to Obtain or Fulfill a Contract — Costs to obtain a contract are incremental direct costs incurred to obtain a contract with a customer and are capitalized if material. Costs to fulfill a contract include costs directly related to a contract or specific anticipated contract (for example, mobilization, set-up and certain design costs) that generate or enhance our ability to satisfy our performance obligations under these contracts. These costs are capitalized to the extent they are expected to be recovered from the associated contract. Capitalized costs to obtain or fulfill a contract are amortized to expense over the expected period of benefit for contracts with terms greater than one year on a systematic basis that is consistent with the pattern of transfer of the associated goods and services to the customer. As a practical expedient, capitalized costs to obtain or fulfill a contract with a term of one year or less are expensed as incurred. We did not have any capitalized costs to obtain or fulfill a contract at January 1, 2021 and January 3, 2020.

Property, Plant and Equipment — Property, plant and equipment are carried on the basis of cost and include software capitalized for internal use. Depreciation of buildings, machinery and equipment is computed by the straight-line method. The estimated useful lives of buildings, including leasehold improvements, generally range between 2 and 45 years. The estimated useful lives of machinery and equipment generally range between 2 and 10 years. Amortization of internal-use software begins when the software is put into service and is based on the expected useful life of the software. The useful lives over which we amortize internal-use software generally range between 3 and 10 years. See *Note 5: Property, Plant and Equipment* in these Notes for additional information regarding property, plant and equipment.

Goodwill — Where pushdown accounting is applied, we follow the acquisition method of accounting to record the assets and liabilities of acquired businesses at their estimated fair value at the date of acquisition. We initially record goodwill for the amount the consideration transferred exceeds the acquisition-date fair value of net identifiable assets acquired.

We test goodwill for impairment at a level within the Business referred to as the reporting unit. We test our goodwill for impairment annually as of the first day of our fourth fiscal quarter, or under certain circumstances, more frequently, such as when events or circumstances indicate there may be impairment. Such events or circumstances may include a significant deterioration in overall economic conditions, changes in the business climate of our industry, a decline in our market capitalization, operating performance indicators, competition, reorganizations of our business or the disposal of all or a portion of a reporting unit.

To test goodwill for impairment, we may perform both qualitative and quantitative assessments. If we elect to perform a qualitative assessment, we evaluate events and circumstances impacting the reporting unit to determine the probability that goodwill is impaired. If we determine it is more likely-than-not that the fair value of the reporting unit is less than its carrying amount, we measure any loss from an impairment by comparing the fair value of the reporting unit to its carrying amount, including goodwill. If the carrying amount of a reporting unit exceeds its fair value, goodwill is considered impaired, and an impairment loss is recognized in an amount equal to that excess. See *Note 6: Goodwill and Intangibles* in these Notes for additional information regarding goodwill.

Long-Lived Assets, Including Intangible Assets — Long-lived assets, including finite-lived intangible assets, are amortized to expense over their useful lives either according to the underlying economic benefit as reflected by future net cash inflows or on a straight-line basis depending on the nature of the asset. We assess the recoverability of the carrying value of our long-lived assets, including finite-lived intangible assets, whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable. We evaluate the recoverability of such assets based on the expectations of undiscounted cash flows from such assets. If the sum of the expected future undiscounted cash flows were less than the carrying amount of the asset, a loss would be recognized for the difference between the fair value and the carrying amount. We did not have any indefinite-lived intangible assets at January 1, 2021 and January 3, 2020. See *Note 5: Property, Plant and Equipment* and *Note 6: Goodwill and Intangibles* in these Notes for additional information regarding long-lived assets and intangible assets, respectively.

Leases — We recognize right-of-use (“ROU”) assets and lease liabilities in our balance sheet for operating leases under which we are the lessee. As a practical expedient, leases with a term of twelve months or less (including reasonably expected extension periods) are expensed as incurred. We did not have any finance leases at January 1, 2021 and January 3, 2020.

Operating lease assets are included in the “Operating lease right-of-use assets” line item in our Combined Balance Sheet. Operating lease liabilities for obligations due within twelve months are included in the “Other accrued items” line item in our Combined Balance Sheet. Operating lease liabilities for obligations due longer than twelve months are included in the “Operating lease liabilities” line item in our Combined Balance Sheet.

ROU assets and lease liabilities are recognized based on the present value of future lease payments. Lease payments include base rent. Our lease payments also include non-lease components such as real estate taxes and common-area maintenance costs. As a practical expedient, we account for lease and non-lease components as a single component. The present value of future lease payments is determined using our incremental borrowing rate at lease commencement over the expected lease term. We use our incremental borrowing rate because our leases do not provide an implicit lease rate. The expected lease term represents the number of years we expect to lease the property, including options to extend or terminate the lease when it is reasonably certain that we will exercise the option.

Operating lease expense is recognized as an operating cost on a straight-line basis over the expected lease term in our Combined Statement of Income.

See *Note 9: Lease Commitments* in these Notes for additional information regarding leases.

Other Assets and Liabilities — No assets within the “Other current assets” or “Other non-current assets” line items in our Combined Balance Sheet exceeded 5 percent of our total current assets or total assets, respectively, at January 1, 2021 or January 3, 2020. No accrued liabilities or expenses within the “Other accrued items” or “Other long-term liabilities” line items in our Combined Balance Sheet exceeded 5 percent of our total current liabilities or total liabilities, respectively, at January 1, 2021 or January 3, 2020.

Income Taxes — The Business follows the asset and liability method of accounting for income taxes. It records the estimated future tax effects of temporary differences between the tax basis of assets and liabilities and amounts reported in the Combined Balance Sheet, as well as operating loss and tax credit carryforwards. We follow very specific and detailed guidelines in each tax jurisdiction regarding the recoverability of any tax assets recorded on the balance sheet and provide necessary valuation allowances as required. The Business regularly reviews its deferred tax assets for recoverability based on historical taxable income, projected future taxable income, the expected timing of the reversals of existing temporary differences and tax planning strategies. The Business calculated the provision for income taxes using a “separate return” method. Under this method, the Business assumes it will file separate returns with tax authorities, thereby reporting its taxable income or loss and paying the applicable tax to or receiving the appropriate refund from L3Harris. As a result, the Business’s deferred tax balances and effective tax rate as a stand-alone entity will likely differ significantly from those recognized in historical periods. The calculation of income taxes on a separate return basis requires a considerable amount of judgment and use of both estimates and allocations. The tax loss carryforwards and valuation allowances reflected in the

Combined Financial Statements are based on a hypothetical stand-alone income tax return basis and may not exist in the L3Harris consolidated financial statements. See *Note 11: Income Taxes* in these Notes. .

The evaluation of tax positions taken in a filed tax return or planned to be taken in a future tax return or claim, involves inherent uncertainty and requires the use of judgment. We evaluate our income tax positions and record tax benefits for all years subject to examination based on our assessment of the facts and circumstances as of the reporting date. For tax positions where it is more likely than not that a tax benefit will be realized, we record the largest amount of tax benefit with a greater than 50 percent probability of being realized upon ultimate settlement with the applicable taxing authority, assuming the taxing authority has full knowledge of all relevant information. For income tax positions where it is not more likely than not that a tax benefit will be realized, we do not recognize a tax benefit in the Combined Financial Statements. Any accrued interest and penalties related to uncertain tax positions is included in the financial statements as a component of income tax expense.

Standard Warranties—We record estimated standard warranty costs in the period in which the related products are delivered. Factors that affect the estimated cost for warranties include the terms of the contract, the type and complexity of the delivered product, number of installed units, historical experience and management's assumptions regarding anticipated rates of warranty claims and cost per claim. Our standard warranties start from the shipment, delivery or customer acceptance date and typically range from one to two years.

Because our products are manufactured, in many cases, to customer specifications and their acceptance is based on meeting those specifications, we historically have experienced minimal warranty costs. Factors that affect our warranty liability include the number of installed units, historical experience, anticipated delays in delivery of products to end customers, in-country support for international sales and our assumptions regarding anticipated rates of warranty claims and cost per claim. We assess the adequacy of our recorded warranty liabilities every quarter and make adjustments to the liability as necessary.

Foreign Currency Translation — The functional currency for our Magnet-Motor business is the Euro, which is also the local currency. Assets and liabilities are translated at current rates of exchange and income and expense items are translated at the weighted average exchange rate for the year. The resulting translation adjustments are recorded as a separate component of equity.

Stock Options and Other Share-Based Compensation — Certain employees of the Business participate in share-based compensation plans of L3Harris. We measure compensation cost for all share-based payments (including employee stock options) at fair value and recognize cost over the vesting period, with forfeitures recognized as they occur. See *Note 14: Related Parties* in these Notes for additional information regarding share-based compensation.

Revenue Recognition — We account for a contract when it has approval and commitment from all parties, the rights and payment terms of the parties can be identified, the contract has commercial substance and the collectability of the consideration, or transaction price, is probable. Our contracts are often subsequently modified to include changes in specifications, requirements or price that may create new or change existing enforceable rights and obligations. We do not account for contract modifications (including unexercised options) or follow-on contracts until they meet the requirements noted above to account for a contract.

At the inception of each contract, we evaluate the promised goods and services to determine whether the contract should be accounted for as having one or more performance obligations. A performance obligation is a promise to transfer a distinct good or service to a customer and represents the unit of accounting for revenue recognition. A substantial majority of our revenue is derived from long-term development and production contracts involving the design, development, manufacture or modification of engines and/or transmissions for military combat vehicles and spare parts according to customer's specifications. Due to the highly interdependent and interrelated nature of the engine and transmission systems which often result in the delivery of multiple units, we account for these contracts as one performance obligation. For contracts that include both development/production of engines or transmissions and the provision of spare parts, we generally consider the spare parts distinct in the context of the contract and account for them as separate performance obligations. Contracts to manufacture engines and transmissions often result in the delivery of distinct units in a series that are substantially the same. We account for each series of engines or transmissions that are substantially the same as a single performance obligation. We

recognize revenue on our engine and transmission contracts using the percentage of completion (“POC”) revenue recognition method as there is no alternative use for the engines, transmissions and spare parts and our contracts include progress payment provisions that provide for the right to bill for cost and profit for work performed to date. A portion of our revenue is derived from the provision of technical support services. Orders for technical support services are typically considered a separate contract. Revenue for technical support services is recognized using the POC cost-to-cost revenue recognition method. Shipping and handling costs incurred after control of a product has transferred to the customer (for example, in free on board shipping arrangements) are treated as fulfillment costs and, therefore, are not accounted for as separate performance obligations. Also, we record taxes collected from customers and remitted to governmental authorities on a net basis in that they are excluded from revenue.

As noted above, our contracts are occasionally modified to include changes in specifications, requirements or price. Depending on the nature of the modification, we consider whether to account for the modification as an adjustment to the existing contract or as a separate contract. Often, given each deliverable within the original contract is distinct, when a customer orders additional similar deliverables, the additional deliverables in our contract modifications are distinct and accounted for as a separate contract.

We determine the transaction price for each contract based on our best estimate of the consideration we expect to receive, which in limited cases includes assumptions regarding variable consideration, such consideration for cost-reimbursable technical support service contracts. We include such estimated amounts in the transaction price to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. We estimate variable consideration primarily using the most likely amount method.

For contracts with multiple performance obligations, we allocate the transaction price to each performance obligation based on the relative standalone selling price of the good or service underlying each performance obligation. The standalone selling price represents the amount for which we would sell the good or service to a customer on a standalone basis (i.e., not sold as a bundle with any other products or services). Our contracts with the U.S. Government, including foreign military sales contracts, are subject to the Federal Acquisition Regulations (“FAR”) and the prices of our contract deliverables are typically based on our estimated or actual costs plus a reasonable profit margin. As a result, the standalone selling prices of the goods and services in these contracts are typically equal to the selling prices stated in the contract, thereby, eliminating the need to allocate (or reallocate) the transaction price to the multiple performance obligations. In our non-U.S. Government contracts, we also generally use the expected cost plus a reasonable profit margin approach to determine standalone selling price. In addition, we determine standalone selling price for certain contracts that are commercial in nature based on observable selling prices.

We recognize revenue for each performance obligation when (or as) the performance obligation is satisfied by transferring control of the promised goods or services underlying the performance obligation to the customer. The transfer of control for substantially all of our revenues occurs over time.

Over Time Revenue Recognition: For U.S. Government development and production contracts, there is a continuous transfer of control of the asset to the customer as it is being produced based on FAR clauses in the contract that provide the customer with lien rights to work in process and allow the customer to unilaterally terminate the contract for convenience, pay us for costs incurred plus a reasonable profit and take control of any work in process. This also typically applies to our contracts with prime contractors for U.S. Government development and production contracts, when the above-described FAR clauses are flowed down to us by the prime contractors.

Our non-U.S. Government development and production contracts often do not include the FAR clauses described above. However, over time revenue recognition is typically supported either through our performance creating or enhancing an asset that the customer controls as it is created or enhanced or based on other contractual provisions or relevant laws that provide us with an enforceable right to payment for our work performed to date plus a reasonable profit if our customer were permitted to and did terminate the contract for reasons other than our failure to perform as promised. Over time revenue recognition for our non-U.S. Government services contracts are typically supported by the customer consuming the benefits from the services as we perform them.

Revenue for our development and production contracts is recognized over time, typically using the series guidance where deliverables are substantially the same and represent a performance obligation satisfied over time.

For performance obligations to provide services that are satisfied over time, we recognize revenue using the POC cost-to-cost method.

Contract Estimates: Under the POC cost-to-cost method of revenue recognition, a single estimated profit margin is used to recognize profit for each performance obligation over its period of performance. Recognition of profit on a contract requires estimates of the total cost at completion and transaction price and the measurement of progress towards completion. Due to the long-term nature of some of our contracts, developing the estimated total cost at completion and total transaction price often requires judgment. Factors that must be considered in estimating the cost of the work to be completed include the nature and complexity of the work to be performed, subcontractor performance and the risk and impact of delayed performance. Factors that must be considered in estimating the total transaction price include contractual cost as well as our historical experience and our expectation for performance on the contract. At the outset of each contract, we gauge its complexity and perceived risks and establish an estimated total cost at completion in line with these expectations. After establishing the estimated total cost at completion, we follow a standard Estimate at Completion (“EAC”) process in which we review the progress and performance on our ongoing contracts at least quarterly and, in many cases, more frequently. If we successfully retire risks associated with the technical, schedule and cost aspects of a contract, we may lower our estimated total cost at completion commensurate with the retirement of these risks. Conversely, if we are not successful in retiring these risks, we may increase our estimated total cost at completion. Additionally, as the contract progresses, our estimates of total transaction price may increase or decrease if, for example, we receive award fees that are higher or lower than expected. When adjustments in estimated total costs at completion or in estimated total transaction price are determined, the related impact on operating income is recognized using the cumulative catch-up method, which recognizes in the current period the cumulative effect of such adjustments for all prior periods. Any anticipated losses on these contracts are fully recognized in the period in which the losses become evident.

Net EAC adjustments had the following impact to earnings for the periods presented (in thousands):

	2020	2019
Net EAC adjustments, before income taxes	\$ 28,378	\$ 23,948
Net EAC adjustments, net of income taxes	\$ 21,057	\$ 18,728

Revenue recognized from performance obligations satisfied in prior periods was \$29,135 and \$21,729 in fiscal 2020 and 2019, respectively.

Backlog: Backlog, which is the equivalent of our remaining performance obligations, represents the future revenue we expect to recognize as we perform on our current contracts. Backlog comprises both funded backlog (i.e., firm orders for which funding is authorized and appropriated) and unfunded backlog. Backlog excludes unexercised contract options and potential orders under ordering-type contracts, such as indefinite delivery, indefinite quantity (“IDIQ”) contracts.

Disaggregation of Revenue: We disaggregate revenue by customer relationship, contract type and geographical region. We believe these categories best depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

	2020	2019
	(In thousands)	
Revenue By Customer Relationship		
Prime contractor	\$ 146,215	\$ 108,326
Subcontractor	90,218	74,390
	<u>\$ 236,433</u>	<u>\$ 182,716</u>
Revenue By Contract Type		
Fixed-price	\$ 221,963	\$ 164,704
Cost-reimbursable	14,470	18,012
	<u>\$ 236,433</u>	<u>\$ 182,716</u>
Revenue By Geographical Region		
United States	\$ 207,979	\$ 135,317
International	28,454	47,399
	<u>\$ 236,433</u>	<u>\$ 182,716</u>

Financial Guarantees and Commercial Commitments — Financial guarantees are contingent commitments issued to guarantee the performance of a customer to a third party in borrowing arrangements, such as commercial paper issuances, bond financings and similar transactions. As of January 1, 2021, we did not have material financial guarantees and there were no such contingent commitments accrued for in our Combined Balance Sheet.

We have entered into commercial commitments in the normal course of business including surety bonds, standby letter of credit agreements and other arrangements with financial institutions and customers primarily relating to the guarantee of future performance on certain contracts to provide products and services to customers and to obtain insurance policies with our insurance carriers.

NOTE 2: ACCOUNTING CHANGES OR RECENT ACCOUNTING PRONOUNCEMENTS

Adoption of New Accounting Standards

Effective January 3, 2020, we adopted Accounting Standards Update 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* on a modified retrospective basis. The new standard replaces the existing impairment model, under which impairment of financial instruments, including accounts receivable and contract assets, is recognized when it becomes probable a loss has been incurred, with a model that requires recognition of expected credit losses over the estimated life of an asset at inception and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Due to the low historical loss rates associated with our customer base and lack of expected credit losses on our existing receivables and contract assets, adopting this standard did not have an impact on our financial position, results of operations, cash flows or equity.

NOTE 3: CONTRACT ASSETS AND CONTRACT LIABILITIES

Contract assets and contract liabilities are summarized below (in thousands):

	January 1, 2021	January 3, 2020
Contract assets	\$ 39,523	\$ 51,317
Contract liabilities, current	(5,782)	(1,454)
Net contract assets	<u>\$ 33,741</u>	<u>\$ 49,863</u>

Our contract assets are composed of unbilled contract receivables at the end of fiscal 2020 and 2019, respectively. There were no impairment losses related to our contract assets in fiscal 2020 or fiscal 2019. In fiscal 2020 and 2019, we recognized \$1,139 and \$3,277 of revenue related to contract liabilities that were outstanding at the end of fiscal 2019 and 2018, respectively.

NOTE 4: INVENTORIES

Inventories are summarized below (in thousands):

	January 1, 2021	January 3, 2020
Work in process	\$ 137	\$ 2,589
Raw materials and supplies	5,454	6,083
	<u>\$ 5,591</u>	<u>\$ 8,672</u>

NOTE 5: PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are summarized below (in thousands):

	January 1, 2021	January 3, 2020
Land	\$ 1,967	\$ 1,967
Software capitalized for internal use	2,351	2,243
Buildings	16,557	16,472
Machinery and equipment	53,347	57,005
	<u>74,222</u>	<u>77,687</u>
Less accumulated depreciation and amortization	(50,404)	(50,842)
	<u>\$ 23,818</u>	<u>\$ 26,845</u>

Depreciation and amortization expense related to property, plant and equipment was \$3,953 and \$4,640 in fiscal 2020 and 2019, respectively.

In fiscal 2020, we disposed of an abandoned Destroyer asset with a net book value of \$3,253.

NOTE 6: GOODWILL AND INTANGIBLE ASSETS

The carrying amount of Goodwill is as follows (in thousands):

Goodwill, gross as of December 28, 2018	\$ 135,975
Accumulated impairment losses as of December 28, 2018	(8,427)
As of December 28, 2018	<u>127,548</u>
As of January 3, 2020	127,548
As of January 1, 2021	<u>\$ 127,548</u>

Intangible assets separately recognized from our business combinations are solely composed of customer relationships. The fair value for customer relationships is determined, as of the date of acquisition, based on estimates and judgments regarding expectations for the estimated future after-tax earnings and cash flows arising from the follow-on sales expected from the customer relationships over the estimated lives, including the probability of expected future contract renewals and sales, less a contributory assets charge, all of which is discounted to present value. We assess the recoverability of the carrying value of our customer relationships whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable. Our customer relationships are summarized below:

January 1, 2021			January 3, 2020		
(In thousands)					
Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
\$ 15,491	\$ (14,977)	\$ 514	\$ 15,491	\$ (14,762)	\$ 729

Amortization expense related to customer relationships was \$215 and \$281 in fiscal 2020 and 2019, respectively.

Future estimated amortization expense for customer relationships is as follows:

	(In thousands)
2021	\$ 164
2022	126
2023	96
2024	74
2025	54
Thereafter	-
Total	\$ 514

NOTE 7: PENSION AND OTHER POSTRETIREMENT BENEFITS

Multi-employer Benefit Plans

Certain of our employees are covered under defined benefit plans legally sponsored by L3Harris. The Business is allocated its relevant share of the net periodic pension costs or income for the L3Harris employee benefit plans by L3Harris. As such, the Business has not recorded any liabilities nor plan assets associated with our participation in these multi-employer plans in our Combined Balance Sheet as of January 1, 2021 or January 3, 2020. Net periodic benefit income allocated to the Business related to our multi-employer plans was \$3,141 and \$917 for fiscal 2020 and 2019, respectively, and is composed of the components summarized below (in thousands):

	Fiscal Years Ended	
	2020	2019
Service cost	\$ 1,036	\$ 887
Interest cost	2,637	3,115
Expected return on plan assets	(6,350)	(5,260)
Amortization of net actuarial loss and prior service cost	(464)	341
Total net periodic benefit income	\$ (3,141)	\$ (917)

Service cost is included within the "Cost of product sales and services" line item in our Combined Statement of Income and the remaining components of net periodic benefit income are included within the "Non-operating income" line item in our Combined Statement of Income.

Defined Contribution Plan

Certain of our employees participate in defined contribution plans sponsored by L3Harris. Our costs related to L3Harris' matching contributions under the defined contribution plans were \$1,184 and \$1,079 for fiscal 2020 and 2019, respectively.

NOTE 8: RESEARCH AND DEVELOPMENT

Business-sponsored research and development (“R&D”) costs are expensed as incurred and are included in the “Engineering, selling and administrative expenses” line item in our Combined Statement of Income. These costs were \$7,935 and \$5,444 for fiscal 2020 and 2019 respectively. Customer-sponsored R&D costs are incurred pursuant to contractual arrangements, principally U.S. Government-sponsored contracts requiring us to provide a product or service meeting certain defined performance or other specifications (such as designs), and are accounted for principally by the POC cost-to-cost revenue recognition method. Customer-sponsored R&D is included in our revenue and cost of product sales and services.

NOTE 9: LEASE COMMITMENTS

We had one operating lease at January 1, 2021 and January 3, 2020 with a lease term in excess of twelve months related to a satellite office and manufacturing facility we operate in Starnberg, Germany. We also had operating leases for automobiles and other equipment used in our offices and manufacturing facilities with non-cancellable lease terms of less than twelve months which are not included in our Operating lease ROU assets or Operating lease liabilities and are expensed as incurred. We had no finance leases at January 1, 2021 or January 3, 2020.

Our lease cost was as follows (in thousands):

	Fiscal Years Ended	
	2020	2019
Operating lease cost for our Starnberg site	\$ 361	\$ 333
Short-term and variable lease cost	281	124
Total lease cost	\$ 642	\$ 457

Supplemental operating lease balance sheet information for our Starnberg site at January 1, 2021 and January 3, 2020 is as follows (in thousands):

	January 1, 2021	January 3, 2020
Operating lease ROU assets	\$ 2,972	\$ 2,995
Other accrued items	300	269
Operating lease liabilities	2,672	2,726
Total operating lease liabilities	\$ 2,972	\$ 2,995

Other supplemental lease information for fiscal 2020 and 2019 is as follows (in thousands except lease term and discount rate):

	Fiscal Years Ended	
	2020	2019
ROU assets obtained in exchange for new operating lease liabilities	\$ -	\$ 2,995
Weighted average remaining lease term — operating leases (in years)	9	10
Weighted average discount rate — operating leases	2.37%	2.37%

Cash paid for amounts included in the measurement of operating lease liabilities approximates the operating lease cost for our Starnberg site and is included in our operating cash flows.

Future lease payments for our non-cancelable operating lease for our Starnberg site at January 1, 2021 was as follows (in thousands):

	January 1, 2021
Fiscal Years	
2021	\$ 366
2022	366
2023	366
2024	366
2025	366
Thereafter	1,465
Total future lease payments required	3,295
Less: imputed interest	(323)
Total	\$ 2,972

These commitments do not contain any rent escalations, rent holidays, contingent rent, rent concessions, leasehold improvement incentives or unusual provisions or conditions.

At January 1, 2021, we had no additional operating lease commitments for real estate leases that have not yet commenced.

NOTE 10: ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (“AOCI”)

The changes in AOCI are included below (in thousands):

	Total AOCI
Balance at December 28, 2018	\$ (537)
Foreign currency translation gain (loss), net of income taxes	(184)
Balance at January 3, 2020	(721)
Foreign currency translation gain (loss), net of income taxes	970
Balance at January 1, 2021	\$ 249

NOTE 11: INCOME TAXES

Income Tax Provision

The provisions for current and deferred income taxes are summarized as follows (in thousands):

	Fiscal Years Ended	
(In millions)	January 1, 2021	January 3, 2020
Current:		
United States	\$ 11,819	\$ 6,033
International	55	319
State and Local	3,277	1,399
	15,151	7,751
Deferred:		
United States	(344)	1,971
International	182	(79)
State and Local	1,229	605
	1,067	2,497
Total Income Tax Expense	\$ 16,218	\$ 10,248

The Business's current provision is the amount of tax payable or refundable on the basis of a hypothetical, current-year separate return. The Business does not make cash tax payments directly to taxing jurisdictions; rather, any federal, international, or state income tax payables or receivables are included in Net Parent Investment.

A reconciliation of the U.S. statutory income tax rate to our effective income tax rate follows (in thousands):

	Fiscal Years Ended	
	January 1, 2021	January 3, 2020
U.S. statutory income tax rate	21.0 %	21.0 %
State taxes	5.7	3.4
Valuation allowance	(0.3)	(1.9)
Other items	(0.6)	(0.7)
Effective income tax rate	25.8 %	21.8 %

Deferred Income Tax Assets (Liabilities)

The components of deferred income tax assets (liabilities) were as follows (in thousands):

	January 1, 2021	January 3, 2020
Deferred tax assets	\$ 9,585	\$ 9,960
Valuation allowance	(5,003)	(4,783)
Deferred tax assets, net	4,582	5,177
Deferred tax liabilities	(29,441)	(29,290)
Net deferred tax assets (liabilities)	\$ (24,859)	\$ (24,113)

Net deferred tax assets (liabilities) were classified as follows in our Combined Balance Sheet (in thousands):

	January 1, 2021	January 3, 2020
Non-current deferred income tax assets	\$ 2,787	\$ 2,748
Non-current deferred income tax liabilities	(27,646)	(26,861)
	\$ (24,859)	\$ (24,113)

Deferred income taxes reflect the net tax effects of temporary differences between the financial statement carrying amounts of assets and liabilities and their respective tax bases (principally relating to tax deductible goodwill and net operating losses).

The tax-effected amount of the German net operating loss carryforwards at January 1, 2021 and January 3, 2020 are \$7,791 and \$7,532, respectively, and do not expire. Of the total \$7,791 German net operating losses, \$5,688 represent hypothetical net operating losses generated during tax return periods where Magnet-Motor filed as part of a German Organschaft tax return filing group. These losses were fully utilized to offset taxable income generated by the remaining entities within the German Organschaft group. However, under a separate tax return methodology, the \$5,688 of net operating losses are deemed "hypothetical" losses of Magnet-Motor for purposes of these financial statements.

With respect to the remaining \$2,103 net operating losses of Magnet-Motor, such losses were generated during tax years where Magnet-Motor filed German corporate tax returns as a stand-alone entity, and prior to joining the German Organschaft tax return group mentioned above. Under German tax law, these losses are not available for utilization in periods where Magnet-Motor was included in the German Organschaft tax return filing group.

However, the \$2,103 of tax-effected net operating losses are retained by Magnet-Motor and could be available for utilization at a time when Magnet-Motor ceases to be included as part of an Organschaft tax filing group or, in the case of Magnet-Motor being acquired, via stock acquisition, the net operating losses may inure to “Acquiror” entity but be potentially subject to further limitations under German tax law.

At January 1, 2021 and January 3, 2020, the Business evaluated all significant available positive and negative evidence as a stand-alone entity, including the results of recent years and management’s forecast of future taxable income, and determined it was more likely than not that certain German net operating loss carryforwards computed on a separate return basis, would not be realized. As a result, the Business has established valuation allowances of approximately \$5,003 and \$4,783 as of January 1, 2021 and January 3, 2020, respectively. These balances are inclusive of full valuation allowances against net operating losses generated prior to Magnet-Motor joining the German Organschaft tax return group.

Tax Uncertainties

As a separate taxpayer under a separate return method, the Business would be deemed to file a US federal, several US state, and German federal and local tax returns. Pursuant to these hypothetical filings, uncertain tax benefits are recorded based on largest amount of tax benefit with a greater than 50 percent probability of being realized upon ultimate settlement with the applicable taxing authority, assuming the taxing authority has full knowledge of all relevant information. The Business’s operating results and related tax positions are a component of either a legal entity and/or a larger group of entities that file tax returns. The Business is not considered to be the primary obligor for uncertain tax benefits taken. Therefore, unrecognized tax benefits for uncertain tax positions taken for the years ended January 1, 2021 and January 3, 2020 are reflected in the provision but are deemed to have been assumed by L3Harris and not reflected in the Business's ending balance sheets for the periods reported.

As of January 1, 2021, there is no accrued interest or penalties recorded in the financial statements related to unrecognized tax benefits.

NOTE 12: BACKLOG

Backlog, which is the equivalent of our remaining performance obligations, represents the future revenue we expect to recognize as we perform on our current contracts. Backlog comprises both funded backlog (i.e., firm orders for which funding is authorized and appropriated) and unfunded backlog. Backlog excludes unexercised contract options and potential orders under ordering-type contracts, such as indefinite delivery, indefinite quantity contracts.

At January 1, 2021, our ending backlog was \$392,378. We expect to recognize approximately 66 percent of the revenue associated with this backlog by the end of 2021 and substantially all of the remaining revenue associated with this backlog by the end of 2023. At January 3, 2020, our ending backlog was \$279,567, at which time we expected to recognize approximately 69 percent of the revenue associated with this backlog within 2020 and substantially all of the remaining revenue associated with this backlog by the end of 2022.

NOTE 13: LEGAL PROCEEDINGS AND CONTINGENCIES

From time to time, as a normal incident of the nature and kind of businesses in which we are or were engaged, various claims or charges are asserted and litigation or arbitration is commenced by or against us arising from or related to matters, including but not limited to: product liability; personal injury; patents, trademarks, trade secrets or other intellectual property; labor and employee disputes; commercial or contractual disputes; strategic acquisitions or divestitures; the prior sale or use of former products allegedly containing asbestos or other restricted materials; breach of warranty; or environmental matters. Claimed amounts against us may be substantial, but may not bear any reasonable relationship to the merits of the claim or the extent of any real risk of court or arbitral awards. We record accruals for losses related to those matters against us that we consider to be probable and that can be reasonably estimated. Gain contingencies, if any, are recognized when they are realized and legal costs generally are expensed when incurred. At January 1, 2021, our accrual for the potential resolution of lawsuits, claims or proceedings that we consider probable of being decided unfavorably to us was not material. Although it is not feasible to predict the outcome of these matters with certainty, it is reasonably possible that some lawsuits, claims or

proceedings may be disposed of or decided unfavorably to us and in excess of the amounts currently accrued. Based on available information, in the opinion of management, settlements, arbitration awards and final judgments, if any, which are considered probable of being rendered against us in litigation or arbitration in existence at January 1, 2021 are reserved against or would not have a material adverse effect on our financial position, results of operations or cash flows.

NOTE 14: RELATED PARTY TRANSACTIONS

Allocation of Corporate Expenses

The Combined Statement of Income includes L3 and L3Harris corporate and segment expenses directly attributed or otherwise allocable to the Business through the application of government cost accounting practices or other reasonable means totaling \$8,230 and \$6,775 for fiscal 2020 and 2019, respectively. Amounts are exclusive of share-based compensation, disclosed below, and multiemployer benefit plan cost (income), disclosed separately in *Note 7: Pensions*.

Related Party Revenues and Cost of Revenues

Related party sales from CPS to L3Harris and its non-CPS affiliates were \$475 for fiscal 2020 and are recorded in the "Revenues from product sales and services" line item in our Combined Statement of Income. There were no related party sales from CPS to L3Harris and its non-CPS affiliates in fiscal 2019. Purchases from L3Harris and its non-CPS affiliates were \$7,366 and \$2,909 for fiscal 2020 and 2019, respectively.

Amounts due to or due from L3Harris are expected to be settled in advance of the close of the Transaction and will not be conveyed. Accordingly, amounts due to or due from L3Harris have been included as part of the "Net parent investment" line item in our accompanying Combined Balance Sheet.

Share-Based Compensation

Certain employees of the Business participate in share-based compensation plans of L3Harris and the Business is allocated the direct cost of such plans. Share-based compensation expense recognized in the Combined Statement of Income was \$175 and \$372 for fiscal 2020 and 2019, respectively. The Combined Balance Sheet does not include any equity issued related to share-based compensation plans of L3Harris.

NOTE 15: SUBSEQUENT EVENTS

The Business evaluated its subsequent events through May 28, 2021, which is the date the accompanying combined financial statements were issued. No material subsequent events were identified.