Spin-off transactions
Addressing the key financial reporting challenges

Understanding the accounting and financial reporting challenges are an essential part of the effective management of a spin-off. A number of key decisions, and specifically the timing of these decisions, can significantly impact the timetable, an entity’s balance sheet, its profit or loss, as well as other parts of the business.

To succeed, companies need a decision-making process and project structure that is guided by well-informed management and backed by experienced third-parties.

EY has been involved in many spin-off transactions and can support you throughout the life cycle of the transaction, including planning and addressing key accounting and financial reporting challenges.

As reported in EY’s 2015 Global Corporate Divestment Study, leading companies view divestments as a fundamental part of their capital strategy, especially to fund growth. In the past year, we have seen M&A activity rise significantly, and businesses are under constant pressure to improve portfolio performance and shareholder returns. In particular, activist shareholders are influencing corporate decisions.

These transactions, whether structured as an outright sale, spin-off, initial public offering or contribution to a joint venture, can be an effective way of releasing capital to shareholders or better aligning an entity’s portfolio of operations with broader strategic goals. As part of this, there has been an increase in the number of spin-offs.

But spin-offs are highly complex and involve numerous decisions, thereby presenting a challenging process for any management team and board, including:
1. Creating a compelling value story
2. Developing financial, tax and operational carve-out project plans
3. Evaluating the experience and capacity within the company to navigate the complexities and achieve the timeline

Effectively managing the many and varied financial reporting and accounting complexities is one of the most important aspects of delivering a spin-off.

EY brings together a dedicated team from FAAS, comprising Transaction Accounting and Capital Markets professionals, that work alongside our Divestment Advisory Services (DAS) team to support your spin-off transaction.
For a spin-off or carve-out, financial statements need to be prepared and audited. These need to reflect the balance sheet and performance of the spin-off business on a stand-alone basis. The complexity and associated level of effort in any carve-out situation is influenced by factors such as:

- The number of countries, legal entities or business units involved
- The extent of entities and business units with shared operations, such as manufacturing facilities or cross-border supply chain management arrangements
- The alignment of the spin-off with existing reporting processes, and the ability to leverage existing financial reporting systems and data
- The consistency of historical financial reporting systems, processes, and personnel
- The changes during recent years to the carve-out business, including acquisitions, divestitures, restructurings or reorganizations

Below are some of the key considerations when approaching a spin-off:

### Understanding the overall transaction
- Determine when the transaction will be authorized
- Determine the type of distribution to affect the spin-off – cash or non-cash
- Determine the point at which the actual spin-off will occur

### Shared operations
- Balance sheet accounts: comingled entities or operations pose a significant challenge to split, e.g., shared inventory, receivables, payables and other accrued liabilities.
- Shared service centers: expenses will need to be allocated where specific identification is not practicable.

### Employee benefits
- Both pension and share-based payment obligations will need to be considered, including the potential for new or revised valuations, depending on the specifics of the spin-off.

### Application of carve-out accounting rules
- Impairment testing at a new or lower level, relevant to the spin-off
- Application of the separate returns basis to calculate the tax charge and provision
- Assessment of treasury operations, including inter-company debt and derivatives

### Preparing carve-out financial information
Tools such as CARVEx, an EY proprietary tool, may help you prepare all types of carve-out reporting and thereby add speed and value to the process. Carve-out audited financial statements under IFRS or US GAAP do not typically represent the “deal-basis” financials that will be critical to evaluating transaction value, and using existing ERP systems can prove impossible. CARVEx efficiently handles large volumes of data, facilitates the preparation of full carve-out financial statements, and bridges audit and deal work streams with user-friendly functionality.

### Future external reporting
An early understanding of the ongoing future reporting obligations of the spin-off business, including comparability of accounting policies and disclosures to sector or peer companies, is key. This includes areas such as segment reporting and disclosure of KPIs, as the spin-off business will be expected to report on an ongoing basis in a manner consistent with the carve-out financial statements.
EY works with you to define and provide the required financial information, within the timeline, that supports the spin-off.

**Strong project management**

Having a clear project plan, with a strong understanding of the key priorities and decisions, is important. The accounting work stream should be clearly connected to the other work streams, such as operational separation and tax. As well as the many carve-out accounting complexities, the project plan should also factor in that the materiality of the spin-off business will likely be much lower, which will impact not only the extent of work for the auditor, but potentially lead to reassessing certain pre-existing accounting policies and practices as part of the spin-off.

We structure the support that we provide around the specific complexities and phases of your spin-off, allowing you to consider the most appropriate accounting at each stage.

EY can help you with:

- **Carve-out financial statements**
  
  For example, an EU prospectus must include at least three years of audited IFRS financial statements for the spin-off business. We can assist with:
  
  - Defining the form and content of the required financial information, based on the specifics of the proposed spin-off
  
  - Data extraction, data analysis, preparation of detailed workings and adjustments, provision of an audit trail and reconciliations to other financial data
  
  - Analysis of the most complex accounting areas, such as the application of carve-out accounting rules and accounting for taxes, as well as consideration of accounting policies, financial reporting and reported KPIs of peer companies relevant to the spin-off

  As part of our support, we can deploy technologies such as CARVEx, as it is often not feasible simply to use the existing ERP or group reporting system.

- **Pro forma and other financial information**
  
  Because of the nature of a spin-off transaction, there will be a need to prepare pro forma and other financial information beyond the financial statements. We can assist management with understanding the information required and also with preparing it.

- **Establishing operations for the spin-off business**
  
  The spin-off business will need to operate as a public company in its own right, including accounting and financial reporting matters. We can assist with defining the appropriate finance structure and processes, and provide guidance on transitional services arrangements.

Our experience of working on spin-offs has highlighted the importance of being able to build teams from across our different service offerings that can respond to the wide variety of client needs specific to this process.
The EY advantage

- **Deep experience across industries**
  Operating alongside EY Divestment Advisory Services, our Transaction Accounting and Capital Markets professionals have extensive experience in a wide range of spin-offs and carve-outs for all types of domestic and global clients.

- **Spin-off preparation and execution**
  Our dedicated Transaction Accounting and Capital Markets personnel understand the specific accounting and regulatory requirements that spin-offs present and mobilize teams rapidly, including across borders, to help implement the spin-off.

- **Strategic advice and tactical execution across the spin-off life cycle**
  We work closely with your team on all aspects of a spin-off plan (financial, tax and operations) through an integrated delivery model.

- **Established carve-out financial statement process and methodology**
  We assist with the development of carve-out financial statements using proprietary management tools, such as CARVEx.

- **Complementary to other advisors**
  We work collaboratively with your bankers, legal advisors, auditors and other advisors in support of the preparation of the necessary financial information and regulatory filings.

Final thoughts

Understanding the key financial reporting challenges and other potential accounting implications, and ensuring they are properly addressed, are essential to managing a spin-off transaction effectively.

Preparation of carve-out financial statements is far from straightforward. The importance of having advisors who are aware of how to navigate the process efficiently and rapidly will go a long way to keeping the spin-off on track, as well as achieving the ultimate objective of delivering shareholder value.

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