Turning to spin-offs
As reported in EY’s latest *Global Capital Confidence Barometer: power and utilities* (April-October 2013), 71% of power and utility companies (P&Us) that are planning divestments expect to pursue the carve-out of one or more business units. 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 asset portfolio with broader strategic goals.

But spin-offs are highly complex and involve numerous decisions that will impact the achievement of the overall objectives. To succeed, companies will need a decision-making process that is guided by well-informed management and backed by third-party specialists.

**Key financial reporting challenges**

While there are currently no International Financial Reporting Standards that deal specifically with spin-off transactions, most – though certainly not all – will fall under IFRIC 17, *Distribution of Non-cash Assets to Owners*. However we are seeing diversity in the application of these guidelines, highlighting the need for management to consider the significant judgements that arise when applying accounting requirements and to call on third-party advisers when in doubt.

EY is helping companies across many industries, including power and utilities, to consider the five key areas under IFRIC 17:

1. How to account for a spin-off transaction initially
2. How to account for a spin-off transaction in subsequent reporting periods
3. How to account for a spin-off transaction at transaction settlement
4. What to do with the associated transaction costs
5. What to disclose in the footnotes to financial statements

It is important to note that IFRIC 17 does not apply to spin-offs when the assets distributed are ultimately controlled by the same party (or parties) before or after the distribution.

**Timing is everything**

The first key challenge in accounting for a spin-off is determining when to recognize the transaction. This may seem straightforward, but it frequently requires judgment to determine when the spin-off decision has been appropriately authorized and the obligation is no longer at the entity’s discretion. As it will also be subject to local regulations and laws, management needs to consider its jurisdiction while working through the decision-making process.

The next challenge is to measure the spin-off. Without exception, all spin-off transactions within the scope of IFRIC 17 are initially measured at the fair value of the assets to be distributed. This is perhaps the most challenging aspect of these transactions, particularly if shareholders must approve the spin-off and be satisfied that a proper value has been ascribed to the business.

The valuation of a power and utilities’ assets is a complex process that is beyond the skill sets of most companies’ management. We work with P&Us to develop methodologies that determine...
the fair value of assets, which may include individual assets, customer relationships, contracts and leases.

Timing is a key consideration in this process because of the advantages of settling the spin-off in the same reporting period as its initial recognition. If a P&U has to account for a spin-off transaction in a subsequent reporting period, it may need to remeasure the fair value of the distribution liability. An entity has to account for the spin-off when the transaction is settled by remeasuring the distribution liability to fair value as at that date. It then de-recognizes the assets (and liabilities, if any) being distributed. Any difference is recognized in profit and loss. If the period between initial recording and settlement straddles multiple reporting periods, utilities may face a valuation mismatch on their balance sheet, particularly when energy contracts are subject to fluctuating commodities and price changes.

Speedy settlement also allows the company to move ahead with its strategy and sends positive messages to the market.

Costs and disclosures
When considering how to account for the transaction costs associated with a spin-off, companies should be aware that these are generally accounted for as a deduction from equity if they are considered to be directly related to the spin-off transaction. Any costs not considered directly related to the spin-off are to be expensed as incurred.

What needs to be disclosed on financial statements, particularly surrounding the carrying amount and fair value of assets, will depend on whether the spin-off distribution liabilities have been declared and recognized before or after the reporting period.

Importance of local knowledge
Local knowledge is critical to the success of spin-offs. The tax implications of these transactions can be complicated and requires specific knowledge of the national jurisdiction and local rules prior to and during the spin-off process.

Utilities will also need to consider specific dividend rules, which may impact their ability to pay cash dividends, especially if they must be distributed from positive retained earnings.

Spin-off success
With divestments, including spin-off transactions, increasingly being used by P&Us, it is critical that management address and understand the key financial reporting challenges. Special attention should be paid to valuations and the prompt settlement of spin-offs in order to maximize the benefits of these transactions.

For more information
Read our full paper, *Spin-off transactions: addressing the key financial reporting challenges, ...*

How we can help
We work with P&U entities on a variety of divestments, including spin-offs, and can support you throughout the lifecycle of a transaction we can provide guidance on the key financial reporting areas in a spin-off, including IFRIC 17, valuations and tax implications.
About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

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In a world of uncertainty, changing regulatory frameworks and environmental challenges, utility companies need to maintain a secure and reliable supply, while anticipating change and reacting to it quickly. EY’s Global Power & Utilities Center brings together a worldwide team of professionals to help you succeed – a team with deep technical experience in providing assurance, tax, transaction and advisory services. The Center works to anticipate market trends, identify the implications and develop points of view on relevant sector issues. Ultimately it enables us to help you meet your goals and compete more effectively.

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EYG no. DX0207
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