Spin-off transactions
Addressing the key financial reporting challenges

Refining IFRS
Mining & Metals

What you need to know

- While there is some specific guidance as to how and when to account for spin-off transactions, significant management judgement is still required.
- A number of key decisions, and specifically the timing of these decisions, can significantly impact an entity’s balance sheet and its profit or loss and potentially other parts of its business.
- Understanding the implications and financial reporting challenges are an essential part of the effective management of a spin-off.

The challenges of managing spin-offs

Mining and metals entities operate in a challenging and ever-changing environment of cost inflation, slowing economic growth, heightened geopolitical risk and volatile prices. With margins squeezed, entities are under continuing pressure to control costs, allocate capital wisely and maximise returns. For entities with sustainable cash flows, strong liquidity and projects close to production, there is strong demand from credit markets that are keen to support them through the provision of funding. In light of this, the sector is shifting its priorities to focus more on cost control, credit quality and disciplined growth, to maximise near-term shareholder returns. Entities are therefore seeking to optimise capital through ongoing appraisals of their portfolios, including seeking to divest non-core assets, to release capital.

Some entities, particularly advanced juniors and mid-tier mining and metals entities, are struggling to realise value for their assets in a competitive, high-risk and often-misunderstood sector. In addition, some majors are exploring new ways to recycle capital from high-cost operations. Other entities are assessing how well aligned each asset in their asset portfolio is with their broader strategic goals. As a result of these and other drivers, some entities across the sector are spinning off individual projects or commodity groups, and/or non-core assets, into separate businesses.

The increasing popularity of spin-offs is a reflection of the struggle some entities face in getting the market to understand and fairly value the assets and their future potential. One of the key benefits of a spin-off is the increased visibility it brings to an entity’s assets. The increased visibility of assets, when underpinned by a well-articulated and focused strategy for how capital will be invested to deliver growth, inspires investor confidence and enables the business – whether a single- or multiple-commodity entity – to be benchmarked against a relevant peer group. Such a strategy is central to maintaining investor support and attracting investment.

As well as bringing visibility and strategic focus (and therefore value) to the core/key asset(s), spin-offs provide investors with the opportunity for direct exposure to the divested ‘hidden’ assets.

In addition to the commercial challenges associated with executing a spin-off, there are some key financial reporting challenges. Despite some existing IFRS guidance, there still appears to be some diversity in practice. We believe this is because significant management judgement is still needed when applying the accounting requirements. In this issue of Refining IFRS, we explore some of these financial reporting challenges and the key areas of judgement.
Defining a spin-off

For the purposes of this publication, we are specifically considering those spin-off activities that involve the creation of a new entity, independent of the existing parent entity. The new entity will house certain assets (or an existing business/division of the parent) that have been transferred - or spun off - into the new entity by the existing parent entity. In return for spinning off the assets, the parent entity will receive shares in the new entity. The parent will then distribute these shares to its existing shareholders, for no consideration.

Spin-offs may also be referred to as spin-outs or demergers.

Key financial reporting challenges

Spin-off transactions result in non-cash distributions to the owners of an entity (these may also be referred to as dividends, but we will use the term ‘distributions’ for the purposes of this publication). IFRS has always required the details of these types of distributions to be presented either in the statement of changes of equity or in the notes to the financial statements. Nevertheless, IFRS had not originally included guidance on a number of key areas, specifically:

- How to initially account for a spin-off transaction
- How to account for a spin-off transaction in subsequent reporting periods (if applicable)
- How to account for a spin-off transaction at transaction settlement
- What to do with the associated transaction costs
- What needs to be disclosed

In response to the lack of guidance and consequent diversity in practice, IFRIC 17 Distribution of Non-cash Assets to Owners (the interpretation) was issued.

We examine in more detail below how the interpretation now addresses each of these areas and we highlight some of the related challenges. We also discuss which types of transactions are likely to fall in scope of the interpretation.

What transactions are in scope?

IFRIC 17 applies to those distributions by an entity to its owners, in their capacity as owners, that:

- Are non-reciprocal (i.e., the owner does not provide the entity with anything in return for receiving the distribution)
- Involve the distribution of non-cash assets, e.g., property, plant and equipment; businesses; or ownership interests in another entity (such as occurs in spin-offs transactions)
- Provide the owners with a choice of receiving either the non-cash assets or a cash alternative
- Treat all owners of the same class or equity instrument equally

The interpretation does not apply to spin-offs where the assets distributed are ultimately controlled by the same party, or parties, before and after the distribution. While one may think this may cause many spin-offs to be outside the scope, because the owners of the original combined group (which contained the assets to be distributed) appear to be the same as those of the entity that will now hold the newly spun-off assets, this is not sufficient on its own.

This is because to be regarded as having control, a contractual arrangement must exist between all shareholders, or a group of individual shareholders, receiving the distribution that provides them with the ultimate collective power (control) over the financial and operating policies of the entity making the distribution. Therefore, without such a contractual arrangement, such transactions would fail to satisfy this requirement.

How we see it

Most spin-offs will fall within the scope of IFRIC 17. This is because they will meet the specified criteria and will generally lack a contractual arrangement between the owners that enables an entity to assert that the non-cash assets are ultimately controlled by the same party, or parties, before and after the distribution.

How to initially account for a spin-off transaction

The two key challenges in initially accounting for a spin-off are:

- When to recognise a spin-off
- How to measure a spin-off

When to recognise a spin-off

In substance, a decision to spin off assets to an entity’s owners represents the intention of the entity to make a non-cash distribution to its owners. Similar to the payment of a cash dividend, a liability must be recognised in relation to the spin-off transaction at the point that the entity is obliged to make the distribution to its owners. Such an obligation arises only once the spin-off decision is appropriately authorised and is no longer at the entity’s discretion. Generally, the point at which this spin-off liability is required to be recognised will precede the point at which the assets are actually spun off.

Similar to the accounting for ordinary cash dividends, the liability in relation to the spin-off transaction is recognised as a reduction in equity.

How we see it

While this may seem straightforward, determining when the obligation is no longer at the entity’s discretion will require management’s judgement. In addition, this determination can be influenced by the requirements of local law. For example, in some jurisdictions, shareholder approval is required before there is a liability to recognise. In other jurisdictions, a declaration by management or the board of directors may be sufficient.
How to measure a spin-off

Without exception, all spin-off transactions within the scope of IFRIC 17 are to be initially measured at the fair value of the assets to be distributed.

If the assets being distributed represent a business, the fair value of the business as a whole could differ from the sum of the fair values of the individual assets and liabilities previously recognised by the distributing entity. This is because the fair value of the business as a whole may also include goodwill, or other assets or liabilities that had previously not been recognised, such as reserves and resources, the value beyond proven and probable reserves and exploration potential.

How we see it

Despite any concerns an entity may have about its ability to reliably measure the fair value of the assets being distributed, it would be difficult to successfully argue that this cannot be done. Indeed, management would be expected to know the assets’ fair value prior to the spin-off in order to ensure that all owners of the entity are properly informed of the value of the intended distribution. This would be particularly relevant if shareholder approval is needed for the spin-off and, hence, the shareholders need to be satisfied that this is a good decision.

Similarly, even if determining fair value means the entity has to make some estimates, this will not undermine the reliability of that fair value. This is because the use of reasonable estimates is essential to preparing financial statements and is common in applying IFRS more broadly.

In addition to recognising the liability to distribute the assets, if these assets (and liabilities, if relevant) meet the requirements of IFRIC 17, then the following occurs:

• Depreciation on those assets ceases
• The assets are to be measured at the lower of carrying amounts and fair value less costs to sell
• The assets (and liabilities, if relevant) are to be presented separately on the face of the balance sheet

How we see it

Given the requirements for when to recognise a liability in relation to a spin-off transaction are very similar to those requirements which would bring the transaction into the scope of IFRS 5, then it is likely that, at the point the liability is recognised in relation to the distribution obligation, the related assets (and liabilities, if relevant) would be treated as held for distribution and the requirements of IFRS 5 would apply.

As noted earlier, generally, the point at which the spin-off liability is required to be recognised will precede the point at which settlement of the spin-off occurs, i.e., when the assets are actually spun off to the owners of the parent. The impact of this, particularly if the recognition of the liability and the settlement of the spin-off straddle a reporting period, is that there will be a mismatch on the balance sheet. This is because the assets to be distributed will be measured at the lower of the carrying amount and fair value less costs to sell (under IFRS 5), and the liability for the distribution will be carried at the fair value of the assets to be spun off, which will generally be higher. Therefore, during the period between initial recognition and final settlement, the mismatch will reduce an entity’s net assets and in some instances the mismatch may even result in negative net assets. Both of these could have negative impacts (e.g., for debt covenant compliance or tax affairs, such as thin capitalisation calculations).

How we see it

Entities looking to avoid an extended period of mismatch on their balance sheets have an increased incentive to settle the spin-off transaction as soon as practical.
How to account for a spin-off transaction in subsequent reporting periods (if applicable)

When there is a reporting period between initial recognition of the distribution liability and final settlement of the spin-off, the entity will need to remeasure the carrying amount of the distribution liability at fair value. Any change in the value of the distribution liability is recognised in equity as an adjustment to the amount of the distribution.

**How we see it**

The requirement to remeasure the distribution liability at fair value at subsequent dates may require significant additional effort and cost. The extent of this will be influenced by:

- The type of assets being distributed and how difficult they are to value
- Major developments within the entity that may have impacted value
- Major developments in the market to which the assets relate
- The time between initial recognition and the date of the reporting period — the longer this is, the more likely the fair value may have materially changed

**How to account for a spin-off at transaction settlement**

When an entity finally spins off the assets and therefore settles the distribution liability, it has to remeasure this liability at fair value as at that date. It then derecognises both the assets (and liabilities, if any) being distributed and the liability for the distribution. Any difference between these two amounts is recognised in profit and loss and presented separately from other items of profit or loss.

We would generally not expect that the difference between these two amounts would to result in the recognition of a loss. This is because:

- The assets treated as held for distribution in accordance with IFRS 5, would have been carried at the lower of the carrying amount or fair value less costs to sell, which would likely be lower than the distribution liability, which is carried at fair value

  Or

- The assets not treated as held for distribution in accordance with IFRS 5 would have been required to be assessed for impairment under other IFRSs, e.g., inventory is carried at the lower of cost and net realisable value under IAS 2 Inventories. Property, plant and equipment is carried at the lower of the carrying amount or recoverable amount (the latter of which can be measured at either value in use or fair value less costs to sell) under IAS 36 Impairment of Assets.

**What to do with the associated transaction costs**

Where an entity incurs transaction costs in the spin-off process, they are accounted for as a deduction from equity if they are considered incremental costs directly attributable to the equity transaction (i.e., the spin-off) that would otherwise have been avoided. Any other costs not considered to be incremental or directly related to the spin-off are to be expensed as incurred.

**What needs to be disclosed**

For those spin-off related distribution liabilities that have been declared and recognised by the end of the reporting period, an entity is required to provide the following information:

- The carrying amount of the distribution liability at the beginning and end of the reporting period
- The increase or decrease in the carrying amount recognised in the reporting period as result of a change in the fair value of the assets to be distributed

If an entity declares a spin-off related distribution after the end of a reporting period, but before the financial statements are authorised for issue, it must disclose:

- The nature of the asset(s) to be distributed
- The carrying amount of the asset(s) to be distributed as of the end of the reporting period
- The estimated fair value of the asset(s) to be distributed as at the end of the reporting period, if it is different from its carrying amount

As noted above, where the assets to be distributed are considered to fall within the scope of IFRS 5, the presentation and disclosure requirements of IFRS 5 would also apply.

**Tax implications and considerations**

Close attention must also be paid to the tax implications of a spin-off transaction, as they can add considerable value to a transaction, especially if the parent entity’s goal is to maximise after-tax proceeds. Not surprisingly, a spin-off transaction will often have significant and complex tax implications that need to be evaluated prior to and during the execution of the transaction. The spin-off can result in a fully taxable gain or loss to the shareholders depending on the structure or form of the transaction.

In addition, in certain jurisdictions, the parent entity that is spinning off the asset(s) may have a taxable income or loss associated with the fair value of the assets being distributed. Finally, many jurisdictions impose transaction based taxes, such as stamp duties or other transfer taxes, on transactions of this type.

There are unique tax planning options available to avoid potential adverse tax levies for entities to consider. For instance, there are circumstances under local country law in which spin-off transactions can be tax free. That said, cross border spin-offs, e.g., distributions to shareholders outside the parent entity’s country, may be taxable in any event.
Finally, the income tax accounting for the entity that has been spun-off may be complex, depending on the tax basis associated with the assets distributed as part of the transaction. This will be driven by the tax treatment of the transaction as either realising a gain or loss or not.

**How we see it**

Managing the tax implications of a spin-off transaction can be complex. Some useful questions to ask to identify some of the tax characteristics of the assets that have been spun off, as well as the parent entity’s tax needs, would include:

- What assets are being spun off?
- What is the tax base of those assets?
- Where are the assets located?
- What tax attributes can the parent entity monetise?
- What tax relief is available?

**Other implications**

There are other potential implications for the business arising from the accounting for spin-offs. For example, depending on the reporting jurisdiction and the specific dividend rules, the pending settlement of a spin-off transaction may impact an entity’s ability to pay cash dividends in the ordinary course of business. This is particularly the case if dividends must be distributed from positive retained earnings. As explained above, the pre-settlement spin-off accounting entries will reduce retained earnings and may even cause negative net assets. So, prior to settlement, this may limit the amount of ordinary cash dividends an entity can pay or may even prevent it from paying ordinary cash dividends at all.

**Final thoughts**

Understanding the key financial reporting challenges and other potential implications, and ensuring they are properly addressed, are essential to effectively managing a spin-off transaction. These will also help ensure that useful information is provided to the users of the financial statements. A failure to clearly articulate the transaction and its impact on, and value to, stakeholders (particularly because spin-offs will often result in a reduction of an entity’s net assets prior to settlement), could negatively impact shareholder value and, in particular, may reduce the perceived value of the spin-off transaction.

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Ernst & Young’s Global Mining & Metals Center

With a strong but volatile outlook for the sector, the global mining and metals industry is focused on future growth through expanded production, without losing sight of operational efficiency and cost optimization. The sector is also faced with the increased challenges of changing expectations in the maintenance of its social license to operate, skills shortages, effectively executing capital projects and meeting government revenue expectations.

Ernst & Young’s Global Mining & Metals Center brings together a worldwide team of professionals to help you achieve your potential – a team with deep technical experience in providing assurance, tax, transactions and advisory services to the mining and metals sector. The Center is where people and ideas come together to help mining and metals companies meet the issues of today and anticipate those of tomorrow. Ultimately it enables us to help you meet your goals and compete more effectively. It’s how Ernst & Young makes a difference.

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