Spin-off Roadmap: PwC's guide to successful spin-offs

Transition and post spin-off issues and considerations

Going for a spin. Confidently divest the right assets at the right time to drive and secure value.

Introduction

How to spin off a business—without spinning out of control

By Mike Niland, US Divestitures Practice Leader

Have you been thinking about spinning off a part of your company into a stand-alone entity? If so, then you probably know it's a long, complex process. It could take anywhere from six months to more than a year, and there is a great deal of work that needs to happen to make sure a spin-off lives up to its promise of delivering a return. But if executed with the right processes and at the right time, spinning off a company can deliver the best possible deal outcome. Focusing on proactive portfolio analysis, strategic optionality and streamlined operational separation are some of the steps that should be followed to increase your chance of success.

When stakeholders on both sides of the deal get the chance to make themselves heard on everything from operations and finance to staffing, the transaction will open the door to creating value, not destroying it. If you can get a spin-off up and running, you:

Gain credibility as a seller and negotiation advantage

- Build a platform for growth by giving both businesses the best chance to thrive
- Reach your full potential by focusing on core tasks
- Reap tax benefits
- Revive shareholder value

Ultimately, spinning off a business can be good for both the parent company (Parent or RemainCo) and the spin-off company (SpinCo). When it's done right, both do better than their peers, creating solid, long-term returns.

Making the right move at the right time

The underlying premise of creating value through a spin-off is to identify a part of your company's portfolio of segments, brands and products that isn't a good fit for your company's core competencies or one that may not be performing to expectations but could flourish under focused leadership.

It's a normal part of the investment cycle. As companies grow, they usually expand their core business, but they can also buy assets with an eye to diversifying their portfolio. Diversification is often good. Sometimes, however, management gets preoccupied by the core business which takes focus away from the other businesses causing them to drag down the overall performance.

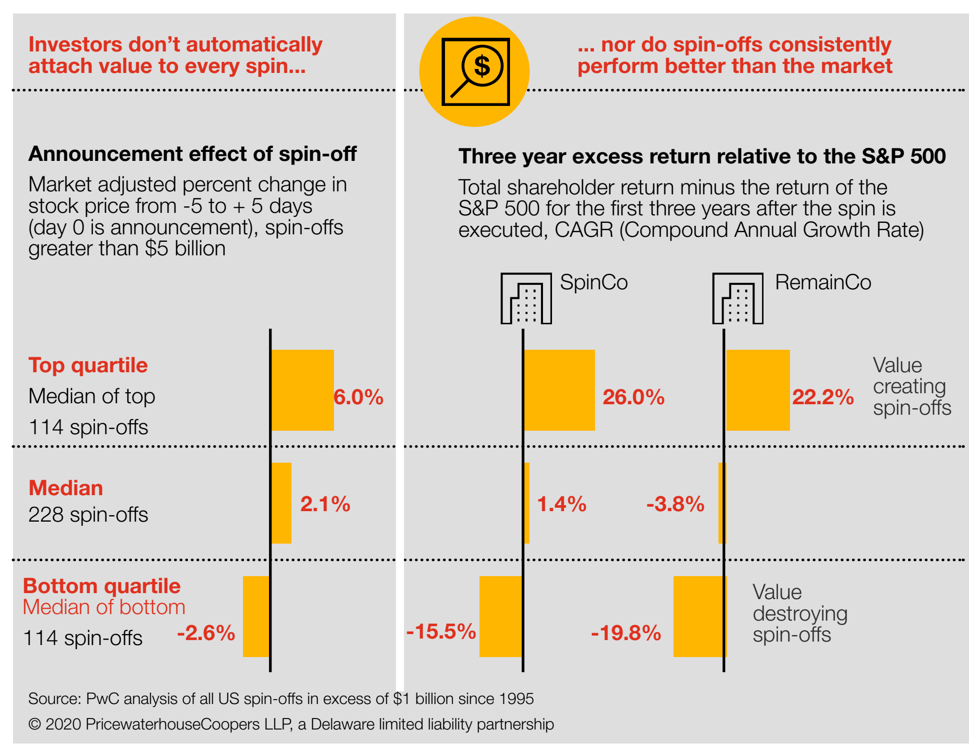
If you've identified a part of your business like this, it's time to think about your options. Whether it's a straight-up trade sale or a spin-off, planning and timing is, as always, critical.

Market pundits often talk about a discount embedded into the stock price of companies with multiple business segments or lines of business. They argue that separating or spinning off businesses will inevitably reduce this discount, unlocking value for shareholders. We analyzed the concept of conglomerate discounts by looking at 900 spins over the past 20 years. Our research shows that spin-offs by themselves are not a magic ingredient to unlocking value. Some spin-offs are successful, some are not. By digging deeper into the details, we were able to clearly understand what some of the critical levers were that set the successful spin-offs apart.

We analyzed the effectiveness of spin-offs by looking at the short- and long-term impact on the stock performance. What we observed corroborates the point that spin-offs don't automatically unlock value for shareholders. Nevertheless, there are plenty of companies that have successfully created value in a spin-off. Companies with top quartile performance generally applied a disciplined approach to the spin-off process. For instance, during the strategic assessment phase, companies typically started with a granular portfolio review, which helped them understand value distribution across the various segments. A deeper dive into the low value segments allowed management to reconsider if the segment needed different capital allocation than the Parent, needed sharper focus and needed specialized capabilities and to ultimately assess if they were the optimal owner for that segment.

Once a spin-off candidate was identified, management established clear strategic plans to maximize value creation based on the identification of key value levers for both entities (SpinCo and Parent) at the most granular level.

The companies that were able to drive significant performance in their stock prices relative to the market were able to unlock value by improving their execution pre and post spin-off.



Initial considerations

Launching a spin-off takes planning and preparation. There are so many moving parts in a successful spin-off that functional areas across the company—from the boardroom to the back office—need to be involved. This is just a sample of what you need to consider when you create a successful and sustainable spin-off:

- Have you assessed the value impact of your spin-off strategy and established a value capture roadmap?
- Have you considered the tax implications to confirm whether a spin-off is the most tax advantageous path forward and if so, do you know the rules to follow?
- Are you taking care of the paperwork? There's a lot to do in preparing financial statements, disclosures and Securities and Exchange Commission (SEC) filings. Missteps here can cause delays.
- What corporate functions will SpinCo take on? We're talking about things like finance, HR, IT, etc.
- Can SpinCo take on these roles right away? Or will there be a transition period before they're handling those duties? If so, how will the two companies handle shared resources?
- Will RemainCo have to absorb stranded costs after the spin-off occurs? For example, RemainCo may end up with more employees than it needs.
- How will the two companies split up their people? This applies up and down the organizational chart, from the factory floor to the corner offices and even the boardrooms.

Learning from our playbook

You don't have to start from scratch when you make these decisions. Plenty of companies have been through the process before. And it's a mistake not to take advantage of all that hard-won experience.

We've been sharing our knowledge with clients for more than a decade on a case-by-case project basis. Now we've formalized that advice to create this spin-off guide. It reflects the latest regulations and leading practices that we think all of our existing and prospective clients should consider as they navigate the spin-off process. It sets out—step by step and function by function—what you need to think about when you're spinning off a business so you'll know what decisions you have to make and when you need to make them.

There's an enormous amount of detail to consider. But we've been able to boil down the basics:

- **Do the right deal at the right time.** Objectivity in considering all your deal options leads to an informed decision that a spin-off would create value while transforming and renewing your company.
- **Create two strong and sustainable companies.** Give the Parent and SpinCo strong management teams and the resources to succeed to build a platform for growth.
- **Get the data you need.** Success means making sure every decision-maker has the right information. You might have to break down company silos to get that data and share it. Go a layer deeper and analyze what the data tells you.
- **Handle the paperwork.** A Spin-off means satisfying regulatory requirements. You'll be more likely to succeed if you make one team responsible and use advanced technology to streamline the process.
- **Start planning now.** Develop a clear breakdown of functional activities, untangle back-office infrastructure and plan for ongoing financial reporting.
- **Focus on details.** If spin-offs fail, it's usually due to poor execution, not bad strategy. To succeed, you should focus your people and capital on executing the right activities at the right times.
- **Get everyone on board.** Change isn't easy. But the chances of success increase if you can motivate your employees to share your vision.

Getting started

If doing a spin-off is the right path for you, we can provide a well-marked roadmap, with many of your options laid out from our years of experience helping clients implement leading practices. We can help you confidently divest the right assets at the right time to drive and secure value. If you have any questions after reading this guide, we're here and waiting to hear from you.

Strategy

Matching strategy with value creation

Every executive in charge of managing a company has one clear goal: to create the most value for stakeholders. That means picking and following the best strategy for your organization. Well-run companies have a dynamic strategy, chosen after careful analysis of what the company is currently doing and where it should be in the future.

In order to do that well, it is important to first understand how the opportunities for value creation are distributed across your business. Second, it is essential to identify key levers of performance which will drive value across different parts of your organization (where should you focus on growth, where should you optimize margins, etc.). Going through this disciplined process at a granular level will help you identify parts of the organization for which you are not the optimal owner and where divesting or spinning off parts of your company will create more value.

In this section we discuss the importance of:

Assessing the value of your portfolio

Assessing the value distribution across your business by brand, product and segment will help you understand the 80/20 rule of value. This means that it is typical to find that 80% of the value is created from just 20% of the activities (brands, geographies, products, etc.)

Developing a strategy to enhance value

Identify the people and operations that comprise the part of the organization to be exited, including who will take charge during the transaction and how to pitch the business to investors.

Assessing the value of your portfolio

Before deciding what part of your business to divest, companies will usually do a detailed portfolio analysis. Breaking down a company's assets by segment, product, brand and customer lets management understand which parts of the business are creating value—or destroying it. Identifying key performance drivers at a granular level allows management to establish a roadmap for how to enhance the value of their company. This type of review usually pinpoints segments, products or brands that could create more value if they were spun off.

A detailed look at the business can help identify the parts where you can increase value for shareholders as well as highlight areas of potential risks. It should also help you answer the following questions:

- Where is value concentrated—in which segments, products and brands?
- Which parts of the business should focus on growth and which should focus on margin?
- Which segments, products or brands drag down the Parent's overall value?
- Which segments, products or brands should you sell?
- Which ones deserve more attention?
- How will changes to the business structure (like selling off or spinning off) affect long-term value? And how will markets react to changes?

Enterprise-wide value heatmap

Illustrative

Intrinsic value/share, in USD

	Brand 1	Brand 2	Brand 3	Brand 4	Others	Total
Segment A	61	48	37	23	21	190
Segment B	49	31	26	12	12	130
Segment C	21	10	10	5	4	50
Segment D	12	8	9	-9	10	30
Segment E	7	3	-2	-11	3	0
Total	150	100	80	20	50	400

In most organizations, ~80% of value is created by only a few core segments

Analysis highlights portfolio assets with limited value contribution, which could be worth more if spun off and managed individually

Segmenting your portfolio through a value lens

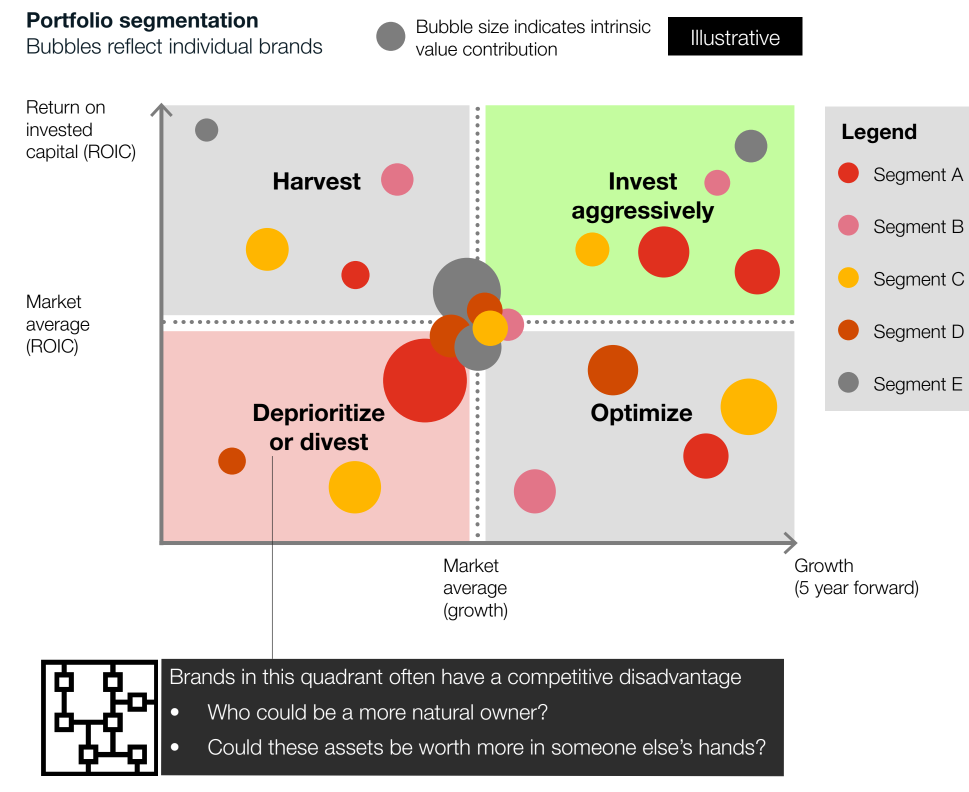
Another critical step towards identifying potential divestiture candidates is performing a portfolio segmentation based on an objective, analytical framework that is grounded in value creation.

Companies typically analyze their segments, brands and products in terms of their value contribution (see previous section), growth and capital returns relative to market benchmarks, in order to identify areas of competitive (dis-)advantage. Segmentation helps companies understand what areas of their portfolio they should aggressively invest in, optimize, harvest (i.e. manage for cash) or deprioritize, in order to maximize shareholder value. For instance, an asset that generates growth and capital returns below peers could be a potential divestiture candidate, and a sale to a more righteous owner or spin-off could extract more value for investors.

A value-based approach towards portfolio segmentation creates several advantages:

- Objectivity—Analytical rigor replaces preconceived notions and organizational politics when it comes to setting portfolio priorities.
- Management alignment—Segmentation creates a common understanding among senior leadership about each asset's strategic role in the portfolio, thereby enabling faster, fact-based decisions.
- Capital allocation—Segmentation informs what areas of the business should receive most resources, both financial and in terms of management focus, to align investment spend with highest at value business opportunities.
- Divestiture candidates—The approach uses financial metrics to uncover areas of competitive disadvantages, highlighting assets where a divestiture or a spin-off to a more natural owner could drive incremental value.

Enterprise-wide value heatmap



Developing a strategy to enhance value

Once you've identified a candidate to divest, create a clear plan to increase shareholder value. The most important part of this process is defining the parameter of the business to be divested. That can happen either by refining an existing strategy or differentiating the strategy of the business to be divested from the Parent's. Getting a clear idea of how the divestiture will create shareholder value, including how the business to be divested compares to RemainCo and what the best opportunities are, is essential for success.

To effectively plan for the divestiture, be sure to consider the following:

- **Find out what will increase value—**Knowing what will improve the performance of the business to be divested and how to measure that is important in creating value for shareholders.
- **Draft a plan—**The plan should include a timeline for using new ways to track performance. It should also name the people responsible for putting these new measures into action as well as those who need to be involved and informed. And there should be a plan to communicate performance internally and externally.
- **Plan how to talk to financial analysts—**The analyst community is an important audience. When thinking about divesting assets, you should understand what the important points are and when to communicate them to analysts. You should also think about what information analysts should get, whether or not to break out segments and divisions when talking to them, whether to release historical information and what drives shareholder value.

Divestitures can be a powerful way for companies to realign their corporate strategy and unlock value. A clear roadmap is critical for a successful divestiture and to unlock value for your shareholders.

For more information on delivering value on your divestiture and proactive portfolio assessment and divestiture strategy, please contact:

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What type of divestiture should you consider?

You have several options to consider when it comes to determining your optimal exit strategy. Depending on the exit structure and approach, the regulatory, tax and reporting requirements can vary significantly and usually involve different timetables. Each strategy is discussed below. Remember to consult with your legal and accounting advisors when deciding the best strategy as each strategy may trigger different tax, accounting and operational outcomes.

- **A spin-off** typically refers to the pro rata distribution of a subsidiary's stock (SpinCo) to the parent's shareholders. The effect of this transaction is to "dividend-off" or carve-out a piece of the company to its existing shareholders. Thus, SpinCo becomes a stand-alone company with its own equity structure. These transactions are referred to as a one-step spin-off. SEC reporting companies typically use spin-offs to enable the separate businesses to more readily pursue individual long-term strategic goals. Additionally, companies often use spin-offs as a tax-free mechanism to unlock value for shareholders. A spin-off does not raise capital for the Parent or the SpinCo. A Parent might raise debt in SpinCo's name prior to, or in conjunction with, the spin-off and retain the cash as a way to monetize its divestiture of SpinCo, but this is a separate transaction preceding the spin-off. After the spin-off, the shareholders own shares in two entities, and the overall value held by the shareholders typically does not change immediately. Although a spin-off is not a sale of securities, SpinCo's newly-issued shares are registered with the SEC. This is typically accomplished by filing a Form 10 for the SpinCo, which generally includes historical stand-alone, carve-out financial statements for the SpinCo and other required historical and pro forma financial information.
- **A two-step spin-off** occurs when a parent offers securities in the SpinCo through an initial public offering prior to executing a pro rata distribution to the Parent's shareholders. Companies use these transactions as a way to build brand value and to fund the working capital requirements prior to the separation from the Parent. Two-step spin-offs are typically undertaken to monetize value in a subsidiary while still retaining control and an interest in its future value. Frequently, the initial public offering is for less than 20% ownership interest in the SpinCo, which typically allows the parent to retain control and avoid any tax implications. The first step in a two-step spin-off, the initial public offering, is an offer of securities to the public requiring the filing of Form S-1 with the SEC. The second step is the distribution by the Parent of its holding of the subsidiary shares to the Parent's shareholders.
- **A split-off** is a transaction in which the Parent gives its stockholders the opportunity to exchange some (or all) of their Parent stock for an interest in one of its subsidiaries (i.e., the carve-out business). The principal difference between a spin-off and a split-off is that after completion of a split-off, the subsidiary's stock is held by the parent's stockholders on a non-pro rata basis. Some stockholders may hold only parent stock, others may hold only subsidiary stock and others may hold both. Some companies may choose a split-off over a spin-off because a split-off gives stockholders an option to participate. This flexibility may be important when stockholders holding a significant interest express a preference for one stock over the other. Like a one-step spin-off, the split-off transaction is not a capital-raising transaction. Similar to a two-step spin-off, a split-off can also be preceded by an initial public offering of securities of the carve-out business to the public (typically no greater than 20%).
- **An initial public offering (IPO)** is when a Parent may carve out a portion of itself to create a new company to be traded on a public exchange. This exit strategy allows a company to raise capital quickly from numerous public investors. This cash can then be used for various purposes including to reinvest in the company, settle outstanding debt or generate capital for future growth.
- **A sale** is the most common way of divesting a business. It is a transaction in which a business is "carved out" and sold to a buyer.
  From the seller's perspective, the sale of a business can provide needed cash, and often has less SEC filing requirements than other options. From the buyer's perspective, the purpose for acquiring the business may vary. Strategic buyers often purchase a business because it complements an existing business or offers operational synergies.
  Financial buyers, such as private equity firms, typically purchase a business with the intent of increasing its value through further development or restructuring with the plan to divest the acquired business via sale or initial public offering in a specific timeframe.

  For the purpose of this guide, we assume the Parent will spin-off its business, but many of the topics discussed are also relevant to other transactions, including split-offs and IPOs.

Transaction execution

Transition planning and governance

Planning for a spin-off can be challenging for a variety of reasons. The implications of a spin-off often mean strict confidentiality is required until the official public announcement, thus limiting disclosure to key people within the organization and external advisors. Coordinating efforts and efficient use of resources to plan and execute a spin-off requires a governance model that ensures teams are focused on the right activities at the right time. A strong governance model will ensure that your executive leadership is informed, can provide guidance around priorities and understands the implications of your spin-off.

In this section we cover:

Defining the initial governance structure

Establishing an effective governance structure is one of the first and most impactful tasks to complete when devising a separation framework. Do it right the first time.

Creating the spin-off roadmap

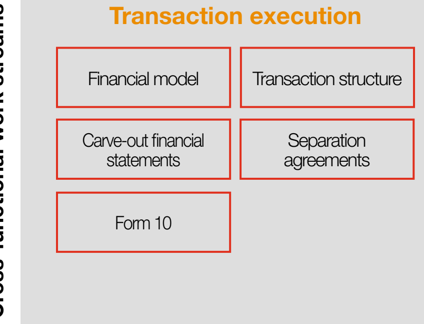
Learn how you can make the spin-off run smoothly with careful planning and a holistic approach to transaction execution and separation.

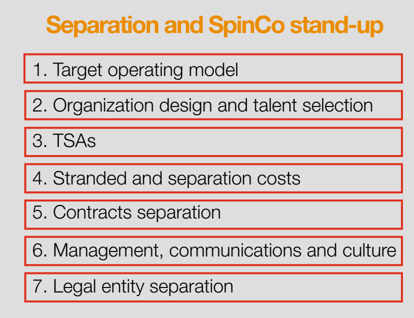
Defining the governance structure

Successful spin-offs establish a governance structure prior to deal announcement. A transition management office (TMO) ensures cross-functional alignment on the structure, approach and timing for transaction execution and operational separation planning. It is important to note the governance structure will evolve as the spin-off progresses.

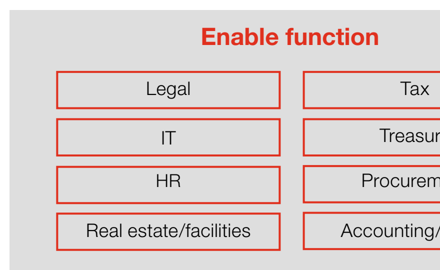
Illustrative transition management office structure

Cross-functional work streams





Functional work streams

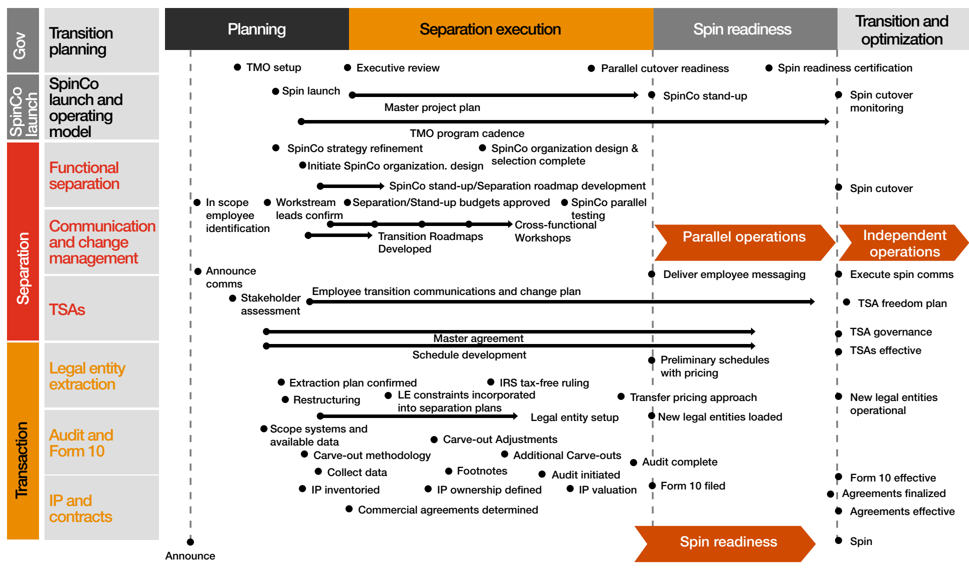


Creating the spin-off roadmap

A growing number of executives are finding they can release trapped value by separating non-core businesses. But they often overlook the value they could unlock by systematically separating corporate functions that support both RemainCo and SpinCo. A holistic approach to separation minimizes stranded costs for RemainCo and keeps SpinCo's stand-alone costs down. But disentangling these intertwined business functions and systems while preparing SpinCo to operate as a public company can be complex, leaving your executives less time to focus and achieve their spin-off goals.

Your spin-off journey requires detailed planning across multiple functional workstreams. Identifying key workstreams, understanding the critical path items that drive the timeline to execute the spin-off and understanding the interdependencies within workstreams and across workstreams provide clarity around resource needs and the timeline to execute the spin-off.

This illustrative separation roadmap shows a sequence of coordinated steps for focusing resources and capital on the right objectives at the right time.



The key to a successful spin-off is careful planning and a holistic approach from transaction execution through separation and transformation.

Spin announcement and communications

The announcement of a spin-off can create significant disruption for a company's employees, customers and partners and generate questions among investors and regulators. Understanding key stakeholders and establishing a plan for actively engaging them throughout the deal lifecycle will help you maximize value and minimize disruption.

Four critical stakeholder groups you should consider:

- Investors and analysts
- Customer, suppliers and partners
- Employees
- Regulators, unions and works councils

A robust communication and change management program should be established early in the planning process. These elements are covered below in more detail throughout the operational separation and optimization section. This section focuses on the preparation for engaging investors and analysts.

Spin-off announcements are carefully orchestrated events and require diligent planning and deft timing. However, there's no typical approach to announcing a spin-off to the market. Depending on the situation and facts surrounding your spin-off, you may use different tactics from what others have used.

The amount of detail on the transaction included in these media can vary significantly. In general, spin-off announcements to the market consist of:

- A press release
- An investor presentation
- An investor call

After the initial announcement, a robust spin-off communication strategy focuses on what information to release and/or discuss during the subsequent investors conference, investor presentations and earnings calls. Management should establish a disciplined and coordinated effort for spin-off related communications to ensure messaging is focused, measured and accurate. Most companies are unwilling to divulge SpinCo's capital structure or other balance sheet information before the spin-off date.

The information that is generally disclosed during the spin announcement and subsequent investor and earnings calls can vary. We've provided below an illustrative example of a communication plan from announcement to spin-off.

Announce	1st Quarter	Subsequent quarters	Spin
Press release	**Earnings call**	**Earnings calls**	**Earnings call**
Info given	Info given	Info given	Info given
Approximate separation date	High-level reasoning for separation	Go-to-Market strategy for SpinCo/RemainCo	Announcement of spin completion
High-level reasoning for separation	Proposed date of separation	Detailed reasoning for separation	Financial carve-out information
Segments of business to be separated	Proposed and updated separation costs	Separation date update	Historical financials with stand-alone SpinCo/Remainco
Tax status-for instance, achieved through distribution which is expected to be tax free	Status of SEC filings	Separation cost update	Separation cost updates
Topline financial information (usually revenues)		SEC filings/approval announcements	Normal business operations
Announce 1-2 top management officials for SpinCo		BOD approval of separation	
Advisor (financial and tax)		Additional SpinCo management	
		Separation details for stockholders	

For more information on delivering value on your divestiture and transaction planning and governance, please contact:

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Tax structure and considerations

Achieving tax free status for a spin-off is fundamental to the viability of separation transactions and involves navigating complex tax rules. The structure for SpinCo will significantly affect the tax position of both the SpinCo and the Parent. Careful planning and execution are paramount to the success of the spin-off strategy.

One of the key drivers of the spin-off strategy is determining whether the spin-off qualifies for tax-free treatment. Several other tax issues—including tax compliance, tax accounting and non-US tax consequences of the spin-off—also need to be considered.

In this section, the term Parent refers to the entity that distributes the shares of a subsidiary to its shareholders (also known as Distributing) and SpinCo refers to the entity whose shares are distributed (also known as Controlled).

In this section we cover:

Federal income tax considerations in structuring and executing a spin-off

There are many federal tax-related benefits to spin-offs, but you'll have to navigate the rules carefully.

State/local and non-income taxes—design, execution and post-spin considerations

Take steps to determine and address state and local filing responsibilities early in the transition process.

International tax

Designing and executing a spin-off that involves a cross-border footprint requires navigating an array of complex issues.

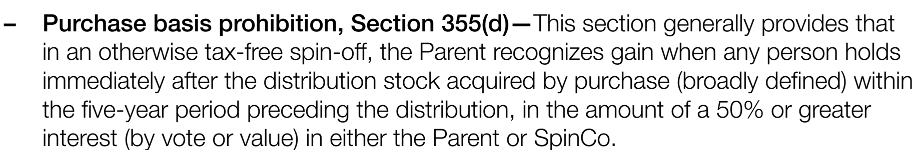
Financial statement impact and reporting considerations

The tax organization must work closely with accounting teams to determine the financial statement impact of the spin-off, as well as to construct separate company income tax provisions.

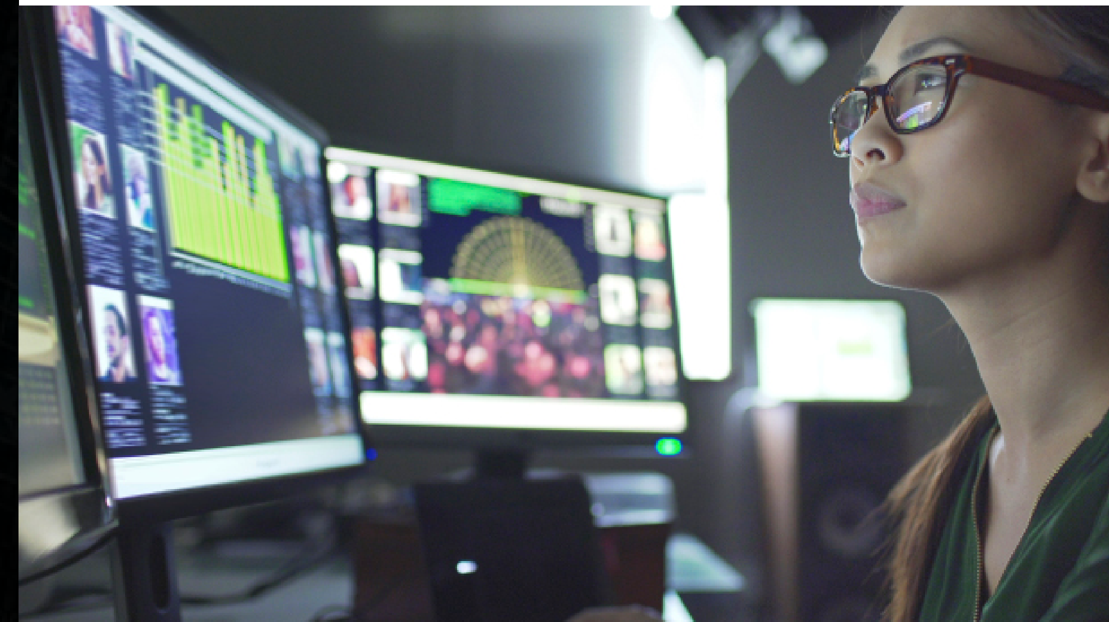
Federal income tax considerations in structuring and executing a spin-off

In planning for a spin-off (as well as a split-off), it's important to critically think through all relevant areas of federal income tax to avoid surprises when the company operates on a stand-alone basis. Below are some of the key areas.

- **Understand the tax-free spin-off requirements—**Careful consideration of complicated tax rules is required to achieve the intended tax-related benefits of a spin-off.
  - **Control requirements—**The Parent must distribute to its shareholders, with respect to such shareholders' stock in the distributing corporation, stock or securities of a corporation that it controls immediately before the distribution. The amount distributed to such shareholders must be equal to or greater than the control threshold.
  - **Active trade or business requirement (ATOB)—**Immediately after the distribution, the Parent and the SpinCo each must be engaged in an ATOB. Additionally, for the five-year period ending on the date of the distribution, the distributing corporation and the controlled corporation must each have been engaged in such an ATOB.
  - **Continuity of interest requirement—**One or more persons who, directly or indirectly, were the owners of both the Parent and the SpinCo before the distribution must own, in the aggregate, an amount of stock establishing continuity of interest in each corporation after the distribution.
  - **Business purpose requirement—**A distribution must be undertaken for one or more non-federal tax corporate (not a shareholder) business purposes. There must be a business purpose for the stock distribution as well as the business separation, and the problem can't be one that's solved by an alternative tax-free transaction that is neither impractical nor unduly expensive. The business purpose requirement for a tax-free spin-off is a higher standard than for other tax-free reorganizations.
  - **The device prohibition—**The distribution must not be used principally as a device for the distribution of earnings and profits (E&P) of the Parent, the SpinCo or both. The device prohibition is intended to prevent the distributing corporation's shareholders from circumventing the code's dividend provisions through a spin-off followed by a subsequent sale or exchange of stock of either the Parent or the SpinCo. All facts and circumstances are relevant, including the strength of the business purpose and the ratio of business to non-business assets in either the Parent or SpinCo.



- **Purchase basis prohibition, Section 355(d)—**This section generally provides that in an otherwise tax-free spin-off, the Parent recognizes gain when any person holds immediately after the distribution stock acquired by purchase (broadly defined) within the five-year period preceding the distribution, in the amount of a 50% or greater interest (by vote or value) in either the Parent or SpinCo.
- **Prohibition on certain acquisition, Section 355(e)—**This section generally provides that in an otherwise tax-free spin-off, the distributing corporation recognizes gain when, pursuant to a plan or series of related transactions that include a spin-off, a 50% interest (by vote or value) in either the Parent or SpinCo is acquired.
- **Intragroup spin-off limitation, Section 355(f)—**This section provides that section 355 won't apply to a distribution of stock from one member of an affiliated group to another member of such group (i.e., an intragroup spin-off) if such distribution is part of a plan or series of related transactions that violates Section 355(e).
- **Disqualified investment corporation, Section 355(g)—**This section provides that section 355 shall not apply to any distribution where either the Parent or SpinCo is, immediately after the transaction, a disqualified investment corporation (generally a corporation whose assets consist of two-thirds or more investment assets) and any person owns, immediately after the transaction, a 50% or greater interest in any disqualified investment corporation, but only if such person did not hold such an interest in such corporation immediately before the transaction.
- **Restrictions on distributions involving a real estate investment trust (REIT), Section 355(h)—**This section provides that section 355 doesn't apply if the distributing or controlled corporation elects to be a REIT.

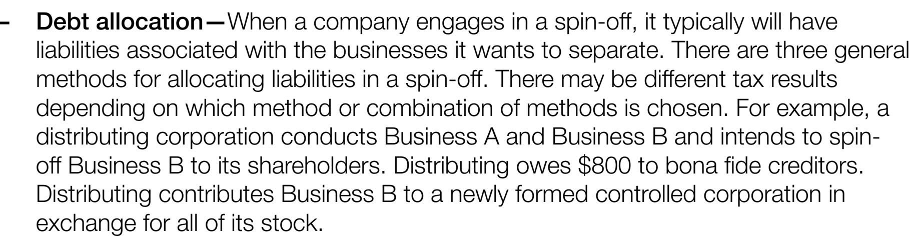


- **Address other considerations in preparing for the spin-off—**From stating the business purpose to setting up the legal structure, a spin-off requires addressing several key considerations before the transaction.
  - **Set up the right legal entity structure—**The complexities of separating SpinCo from the Parent and its other subsidiaries on a tax-free basis can't be overstated. Many issues and opportunities will arise during the process, such as how much debt to allocate to the SpinCo, splitting up certain legal entities with integrated operations, foreign country tax considerations and several other issues. The ultimate structure adopted will affect the tax position of the Parent and SpinCo post spin-off. Determining the structure of SpinCo can be extremely complex and have significant tax implications.
  - **Consider private letter ruling and tax opinion—**Given the ramifications to the shareholders and corporations involved if the Internal Revenue Service (IRS) determines the spin-off is taxable, an advance private letter ruling and/or tax opinion from a recognized national law or accounting firm is strongly recommended. Because a significant amount of analysis is required to undertake a spin-off (e.g., stock basis calculations, identification of deferred intercompany transactions), this process should begin as early as possible. When considering whether to seek a spin-off private letter ruling, corporations should be aware of ever-changing IRS ruling practices related to spin-off. In 2013, the IRS dramatically curtailed its letter ruling program by announcing it no longer would rule on the overall tax consequences of certain transactions, including spin-off, non-divisive reorganizations, contributions and liquidations. Instead, it would rule only on "significant issues" presented in such a transaction. A significant issue was defined as "an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction." In 2017, the IRS reversed course to an extent and introduced an 18-month pilot program that allows the IRS to issue a "transactional ruling" on the tax consequences of a spin-off. This program was made permanent in 2019 which allows taxpayers to seek transactional rulings for a spin-off into the foreseeable future. Transactional rulings not only may provide the tax consequences of the transaction itself, but also may include tax consequences with respect to earnings and profits, tax basis, holding period consequences and the consolidated return regulations. This represents a significant opportunity for companies because it reopens the door to letter rulings addressing the tax consequences of a spin-off. The IRS ruling policy on narrower "significant issues" continues to apply to non-divisive reorganizations, contributions and liquidations, even if such transactions occur in connection with a spin-off. Generally, the IRS tries to process and approve a section 355 ruling within six to eight months from the time of the request. However, the more complicated section 355 rulings may be subject to longer waiting periods.
  - **Determine the corporate business purpose for the spin-off—**A corporate business purpose is a prerequisite for qualifying for a tax-free spin-off. The IRS will no longer provide companies a ruling approving the business purpose of a spin-off, but it has provided significant guidance in this area over the years (e.g., in revenue rulings and Rev. Proc. 96-30). While a shareholder benefit alone won't support a spin-off, a purpose that benefits both the shareholders and the corporation can support a tax-free spin-off. Gathering the internal and external documentation supporting the corporate business purpose(s) can be arduous but is essential. Since the IRS will not rule on business purpose even when a spin-off letter ruling is issued, obtaining a tax opinion on the merits of the business purpose from a recognized national law or accounting firm is recommended.
  - **Calculate the tax basis of the SpinCo—**In a consolidated group, the stock basis of the SpinCo or one or more of its subsidiaries could have potentially been reduced to below zero through current or prior year activity. This negative stock basis is referred to as an excess loss account (ELA). A tax-free spin-off may nonetheless cause a taxable gain to be recognized by the Parent equal to the amount of the ELA incurred by the SpinCo or any of its subsidiaries when they leave the Parent's consolidated group in the spin-off. As such, the Parent and SpinCo should calculate the tax basis in the stock of each of its subsidiaries to ensure the spin-off doesn't cause unanticipated gains from ELAs to be recognized. Note that such ELAs can potentially be "cured" prior to the spin-off to avoid the recognition of taxable gain. In addition, a stock basis calculation for the SpinCo and its subsidiaries should also be done to properly analyze the amount of debt, if any, that can be incorporated into the SpinCo before the spin-off.

- **Identify deferred intercompany transactions—**Any deferred gain or loss from prior intercompany transactions generated by the Parent or the SpinCo could be triggered and recognized as taxable income or loss upon spin-off. Such gains or losses could have inadvertently been created due to prior year activity such as legal entity restructuring (e.g., in prior years a first-tier subsidiary of the SpinCo distributed the stock of a second tier subsidiary to the Parent). The potential impact of deferred intercompany transactions on the Parent and/or SpinCo's current tax liability, if any, needs to be considered. Generally, a stock basis calculation will assist in identifying prior deferred intercompany transactions with respect to stock of subsidiaries of the consolidated group.
- **Consider tax sharing/indemnification agreement—**This agreement will define the responsibilities/liabilities of SpinCo to the Parent after the spin-off. A limit on corporate transactions/reorganizations will likely be included in the agreement to limit the exposure for disqualifying the tax-free nature of the spin-off. SpinCo should negotiate the shortest possible limits with the Parent, likely two years. The agreement should also specify the notification requirements to the Parent when SpinCo enters corporate transactions within the time frame specified in the agreement. The agreement should also state procedures whereby the Parent either accepts the notification or requires the SpinCo to obtain a private letter ruling or tax opinion to ensure the continued qualification as a spin-off.
- **Consider Section 336(e) election—**A section 336(e) election may be made to treat a disposition of target stock as an asset disposition if such disposition is a qualified stock disposition. In the context of a spin-off, a section 336(e) election can be made for a section 355 distribution that is made to an unrelated person (e.g., a public spin-off) and gain is recognized under section 355(d)(2) or (e)(2). Section 355(e)(2) will apply if it is determined that an acquisition and a distribution are part of one plan. In a typical case, the distributing corporation may not know at the time of the distribution of its controlled subsidiary whether section 355(e)(2) will apply, particularly where the distribution occurs before the acquisition. Absent a section 336(e) election, the distributing corporation will recognize any gain on the distribution. However, there will be no concurring increase in the basis of the assets of the controlled corporation. To prevent this adverse result, the regulations provide for a protective election that will be effective only if the distribution is taxable under sections 355(d)(2) or (e)(2), since otherwise there would not be a qualified stock disposition. The election is binding and irrevocable. This election should be discussed within the tax sharing agreement.

There are additional tax considerations to contemplate to ensure you are prepared for your spin-off. Some of the more significant items are below.

- **Common tax considerations in a spin-off**
  - Active trade or business (ATOB)
    - **Separate affiliated group rules—**As described above, both the distributing and controlled corporations must be engaged, immediately after the distribution, in an ATOB. In 2005, Congress amended the ATOB requirement to provide that, for purposes of determining whether a corporation is treated as engaged in an ATOB, all members of the corporation's separate affiliated group (SAG) (i.e., an affiliated group of which distributing or controlled are treated as the Parent) are treated for most purposes as divisions of one corporation. The SAG rule makes it easier for corporations to qualify for the ATOB requirement as long as an ATOB is present either in any subsidiary that is a member in the SAG or, even if no single entity has a qualifying business, the distributing and controlled corporations are treated as engaged in an ATOB if all activities of the component members of its SAG can be aggregated.
    - **Size of the ATOB—**Neither the statute nor the regulations make specific reference to the required size of the ATOB. Nevertheless, recently proposed regulations do so by introducing the requirement that, to satisfy the ATOB requirement, the value of the assets comprising the business that would otherwise qualify must be at least 5% of the value of the Parent's total assets. Included in the value of the assets of SpinCo are reasonable amounts of cash and cash equivalents held for working capital and assets held for business exigencies or regulatory purposes. The proposed regulations also provide operating rules when assets are owned indirectly by the distributing or controlled corporation through a partnership. Even if the proposed regulations are never finalized, the IRS has incorporated this requirement into its letter ruling representations placing great importance on valuation and also forcing companies to determine whether a particular asset is characterized as a business or non-business asset for the purpose of the 5% threshold.

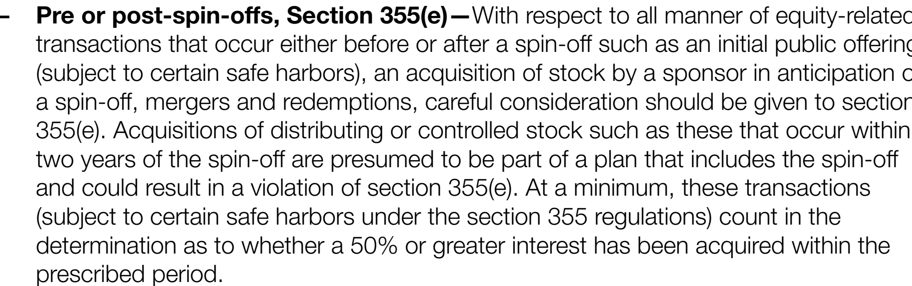


- **Debt allocation—**When a company engages in a spin-off, it typically will have liabilities associated with the businesses it wants to separate. There are three general methods for allocating liabilities in a spin-off. There may be different tax results depending on which method or combination of methods is chosen. For example, a distributing corporation conducts Business A and Business B and intends to spin-off Business B to its shareholders. Distributing owes $800 to bona fide creditors. Distributing contributes Business B to a newly formed controlled corporation in exchange for all of its stock.
  - **Leveraged distributions—**In connection with the reorganization, the controlled corporation borrows $400 and distributes the proceeds to the distributing corporation. Distributing then distributes all of its stock in the controlled corporation to its shareholders and uses the $400 from controlled to pay some of its creditors. The amount that the distributing corporation is allowed to receive from the controlled corporation in a tax-efficient manner is limited to the tax basis of the Business B assets contributed to controlled. Distributing will be required to recognize gain to the extent the amount of cash received exceeds the tax basis of the assets contributed.
  - **Liability assumption—**In lieu of making a leveraged distribution, the controlled corporation may assume $400 of the distributing corporation's liabilities. Similar to a leveraged distribution, the amount of the liabilities that the controlled corporation is allowed to assume in a tax-efficient manner is limited to the tax basis of the Business B assets contributed to controlled. Distributing will be required to recognize gain to the extent the amount of liabilities exceeds the tax basis of the assets contributed.
  - **Securities exchange—**In lieu of leveraged distributions or a liability assumption, a controlled corporation may issue securities with a principal amount of $400 (or some higher amount) to a distributing corporation, and distributing uses those securities to retire its existing debt. Unlike a leveraged distribution or a liability assumption, under current law, there's no tax basis limitation on the amount of securities that may be issued by controlled to distributing.
- **IRS ruling position on debt assumption and satisfaction in a spin-off—**The IRS issued a revenue procedure (Revenue Procedure 2018-53), which details its ruling position to taxpayers seeking private letter rulings for transactions that include the assumption or the satisfaction and retirement of certain debt of a distributing corporation as part of a divisive spin-off. The revenue procedure includes information and analysis that a taxpayer depending on the facts must submit as well as a set of new representations that the taxpayer must provide when requesting a private letter ruling. Taxpayers should consult this revenue procedure if they are considering debt assumption or debt satisfaction as part of a spin-off.
- **Control requirement and dual voting class structures—**As discussed above, for a spin-off to qualify as tax-free, the distributing corporation must distribute to a shareholder stock of a corporation that it controls immediately before the distribution. For this purpose, "control" is defined as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of each other class of stock. If a corporation can't meet this requirement, it may engage in a recapitalization before the distribution to satisfy the control requirement. Except where the safe harbor applies (described below), the IRS can apply step transaction doctrine to determine whether any subsequent unwind of the pre spin-off recapitalized structure is transitory and lacks substance. In general, a post spin-off unwind will fall within the safe harbor provisions if no action is taken (including the adoption of any plan or policy) at any time within two years of the spin-off that would actually or effectively result in an unwind or if the unwind is a result of an unanticipated third-party transaction.

- **Device prohibition and calculation of business vs. non-business assets—**Under the regulations currently in effect, the determination of whether a transaction was used principally as a device takes into account the nature, kind, amount and use of the assets of distributing and controlled corporations (and corporations controlled by them) immediately after the spin-off. In 2005, responding to a concern regarding so-called cash rich split-offs, section 355(g) was enacted to address transactions in which a distributing corporation would use section 355 to effectively redeem its shareholders with a controlled corporation that held a significant amount of cash or other liquid assets. Concerned that certain pro rata spin-off exhibited the same abuse potential, recently proposed regulations make significant changes to one of the current device regulation's factors to be taken into account in determining whether a spin-off was used principally as a device (see above for a description of the device prohibition). The proposed regulations introduce a distinction between business assets and non-business assets, with the former defined as gross assets used in one or more businesses, including cash and cash equivalents held as a reasonable amount of working capital for one or more businesses. Any assets that qualify as used in an active trade or business regardless of the period during which such trade or business has been conducted, are considered business assets. Non-business assets would be a corporation's gross assets other than its business assets. The proposed regulations require taxpayers to determine the amount of business assets and non-business assets owned or deemed owned by distributing and controlled corporations and to compare their relative non-business asset percentages with each other and would specify under what circumstances such ownership and such percentage are considered to be evidence of a device. Similar to the ATOB requirement, if finalized, these rules will require companies to analyze whether a particular asset is characterized as a business or non-business asset in the separation for purposes of this device factor.

  To address the same concern, the IRS in 2017 updated its ruling policy for spin-off and now requires taxpayers to make one of the following alternative representations for purposes of the device prohibition:

  - Immediately after the distribution, the fair market value of the gross investment assets of each of the distributing and controlled corporations will be less than two-thirds of the fair market value of its total gross assets.
  - Immediately after the distribution, the fair market value of the gross assets of the trade(s) or business(es) on which each of the distributing and controlled corporations relies to satisfy the active trade or business requirement of section 355(b) will be 10% or more of the fair market value of its gross investment assets.
  - Immediately after the distribution, the ratio of the fair market value of the gross investment assets to the fair market value of the gross assets other than the gross investment assets of the distributing or controlled corporation will not be three times or more of such ratio for the other corporation.



- **Pre or post-spin-offs, Section 355(e)—**With respect to all manner of equity-related transactions that occur either before or after a spin-off such as an initial public offering (subject to certain safe harbors), an acquisition of stock by a sponsor in anticipation of a spin-off, mergers and redemptions, careful consideration should be given to section 355(e). Acquisitions of distributing or controlled stock such as these that occur within two years of the spin-off are presumed to be part of a plan that includes the spin-off and could result in a violation of section 355(e). At a minimum, these transactions (subject to certain safe harbors under the section 355 regulations) count in the determination as to whether a 50% or greater interest has been acquired within the prescribed period.

  After executing the spin-off, you should be aware of certain tax-specific implications based on the nature of your transaction, as summarized below.
- **Post spin-off transactions involving distributing or controlled redemptions—**
  Where the distributing or controlled corporation redeems stock relatively soon after a spin-off, consideration should be given to the device restriction and section 355(e). In the public company context, stock repurchase programs often are in existence at the time of a spin-off or may be adopted soon afterward. With respect to the device restriction, certain redemptions by public companies have historically not been considered a device if:

  - The redemption was motivated by a sufficient business purpose.
  - The stock to be redeemed was widely held.
  - The redemption was effectuated through an open market transaction.
  - There was no plan or intention that the aggregate amount of redemptions would equal or exceed 20% of the corporation's total outstanding stock.

  The IRS appears to continue to adhere to this standard even though it no longer rules on factual device issues. With respect to section 355(e), a redemption reduces the percentage stock ownership interest of the redeemed shareholder and increases the percentage interest of the unredeemed shareholders. While section 355(e) is more likely to be implicated for redemptions in a closely-held corporation, the issue also can arise in the public company context if a post spin-off redemption pursuant to open market stock repurchase programs occurs in connection with other stock acquisitions during the statutory presumption window, and collectively there is a 50% or greater stock ownership shift. In this context, the IRS has viewed open market stock repurchases as having been made pro rata from all public shareholders, such that the effect is that the percentage ownership interests of the public shareholders remain the same after the stock repurchases so there is no indirect acquisition by the unredeemed shareholders.
- **Post spin-off mergers with overlapping shareholders—**In a Morris Trust transaction, following a spin-off, a third-party corporation merges with the distributing corporation. In a Reverse Morris Trust transaction, following a spin-off, a third-party corporation merges with the controlled corporation. If the shareholders of the third-party corporation end up owning 50% or more of the stock of the combined entity, section 355(e) may be implicated. In the public company context, the application of section 355(e) may be negated by demonstrating that the combined entity has overlapping shareholders such that the 50% threshold has not been met with new shareholders. The IRS has allowed taxpayers to demonstrate the presence of overlapping shareholders through the actual knowledge of the public company's investor relation group. If taxpayers don't have actual knowledge of the overlapping shareholders, the IRS has allowed taxpayers to rely on publicly available information such as:

  - Securities and Exchange Commission filings made by institutional investment managers (Form 13F) and registered management investment companies (Form N-Q and Form N-CSR)
  - Voluntary disclosures to investment research companies
  - Voluntary postings on the publicly available portion of the investor's or the investment advisor's websites
  - To the extent there has been no decrease to such shareholders direct or indirect ownership, such shareholders will be disregarded in determining whether there has been an acquisition of a 50% or greater interest in the distributing or controlled corporation.
- **Contingent dividends—**If future non-deductible payments may be required from the SpinCo to the Parent, declaration of a contingent dividend should be considered by the Parent in order to take advantage of the dividends received deduction.

State/local and non-income taxes—design, execution and post-spin considerations

In anticipation of operating as a separate entity, the SpinCo will be required to address a variety of state and local tax issues. Accordingly, the SpinCo should take steps to determine and address its state and local filing responsibilities early in the transition process. The SpinCo should also consider the planning necessary to optimize its structure and to minimize the overall state and local tax burden.

State and local tax considerations

Pre spin-off considerations include assessing potential state and local tax liabilities, impact on state tax attributes and compliance and reporting responsibilities for state income/franchise and non-income taxes (e.g., sales/use, real estate transfer, real property transfer gains, motor vehicles and other state transfer taxes, etc.).

- **State income tax—**Certain states don't permit combined or consolidated state income tax filings. This may result in immediate gain recognition and/or different tax implications. Examples include:
  - State treatment of excess loss accounts (i.e., negative basis) and/or related concepts
  - State treatment of contributions of assets to a newly formed entity in anticipation of a future spin-off, including potential gain triggered upon contributions of property with liabilities in excess of basis (which may be deferred for federal income tax purposes)
  - State treatment of secondary steps undertaken in conjunction with the spin-off transaction (e.g., intercompany account/debt clean-up, other concurrent reorganization efforts, etc.) that may similarly result in immediate gain recognition rather than deferral of such gain

  In executing your spin-off, consider establishing processes to address state tax issues:
  - Assess the potential impacts to any available tax attributes which may exist for state income tax purposes but not federal tax purposes (e.g., state specific credits, incentives, net operating losses, recapture issues, etc.).
  - Review the allocation of earnings and profits and tax basis for state purposes, monitoring differences that may exist compared to calculations prepared for federal tax purposes (e.g., lack of earnings investment adjustments to basis, etc.).
  - Review the necessity for state tax contingency reserves and the benefits of booking reserves on the opening balance sheet from an accounting perspective.
  - Determine the impact of accounting adjustments, specifically for any increases to net worth or paid in capital that may result in an increase to franchise/net worth based taxes prospectively.
  - Perform a stand-alone nexus study to determine new filing requirements. Prepare income/franchise and non-income tax filing calendars with due dates, including an analysis of short-period or full-year state filing requirements.
  - Perform a detailed review to determine the proper filing methodology (e.g., combined, separate company, unitary, etc.) in all relevant states as well as any corresponding elections (e.g., California water's edge election, etc.) that may be beneficial or required.
  - Evaluate SpinCo's state tax compliance staff needs, including any third-party advisors and/or software platforms.

Non-income tax considerations

To appropriately plan for the spin-off, consider establishing processes during the pre-spin-off phase—as well as processes that could apply in the post spin-off phase—to address non-income tax issues:

- Analyze state transfer taxes—including sales tax, real estate transfer tax, deed recordation tax and controlling interest transfer tax—which may result from any pre spin-off or the spin-off itself.
- Assess what new non-income tax registrations/licenses may be necessary and whether any new filing obligations may be required.
- Consider whether any sales tax certificates (e.g., sale for resale, manufacturing, direct pay, etc.) may be required to be reissued to vendors or re-collected/renewed from customers in the name of the SpinCo.
- Consider transferability of property tax abatement/benefit agreements (e.g., tax incremental financing or payment in lieu of tax) negotiated before change in ownership and any implications of clawback/recapture/change in control provisions. Also consider whether the spin-off will affect any pending or ongoing challenges to assessed value.
- Consider whether the spin-off may result in a revaluation for property tax purposes as a result of the change in ownership (e.g., under California Proposition 13), which may increase prospective property tax payments.
- Evaluate whether any assets may need to be retitled, reregistered or otherwise updated (e.g., motor vehicle registrations).
- Review transfer tax filing requirements from the transaction, including sales tax, real estate transfer tax, deed recordation tax and controlling interest transfer tax.
- If applicable, consider documenting reasoning for any exemptions that may be claimed in a memo or similar file reflecting the reasoning for no tax being due to start the statute of limitations in those states that may attempt to aggregate later transfers with any prior transfers within a predetermined time frame (e.g., New York, Pennsylvania).
- Determine bond requirements—transfer or reissuance, if applicable.
- Address business license requirements that may result from the change in ownership and officers.

Other tax considerations

In planning for the spin-off, consider the additional tax-related items below.

- Consider voluntary disclosure agreements (VDAs) for any potential historical exposures which may have been identified (e.g., states in which SpinCo may have nexus but where returns may not have been previously filed).
- Undertake a comprehensive state and local tax review to identify potential tax planning opportunities. In considering planning alternatives and structures, management should model various state and local tax positions to make certain it meets overall business objectives while minimizing current and future state taxes.
- Review the organizational structure of the entire business to determine opportunities for reducing state income and net worth taxes (subject to state-specific addback requirements, arms-length requirements and other general tax principles). For example, SpinCo's liability may be reduced by establishing separate service companies in high income or net worth states or by establishing separate companies in non-income non-net worth tax states.

Beyond the planning process, the following items should be considered when doing the spin-off.

- Review the intercompany financing structure to ensure interest expense is optimized to offset taxable income in entities that have a high state effective tax rate, especially those entities with significant presence in separate-filing states, subject to various federal and state interest deductibility limits.
- Establish intercompany management fee agreements to potentially reduce the tax base in high tax rate states and to avoid situations where separate company losses cannot be used on a current year basis, subject to state intercompany add back provisions.

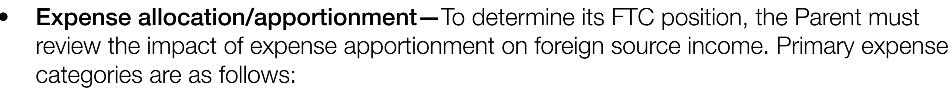
Finally, as you look at the post spin-off environment, the following items should be considered to ensure the RemainCo is maximizing potential benefit.

- Review state tax credits for current facilities and for future expansion projects, including whether the spin-off represents a change in ownership for purposes of terminating/recertifying tax credits.
- Determine if maximum benefit is being derived for exemptions and credits related to sales/use tax matters (e.g., research and development or manufacturing exemptions).
- Determine whether SpinCo qualifies to receive successor employer treatment for unemployment taxes, and whether such treatment would be beneficial compared to that of a new employer.

International tax considerations

Management teams of the Parent and SpinCo must navigate an array of complex issues in designing and executing a spin-off where the businesses that are retained or spun off have a cross-border footprint. During the planning process, you should carefully think through the following international tax-related considerations.

- **International network of advisors—**Local country international tax advisors should be identified and consulted regarding spin-off issues. These local country advisors should be formally notified of the planned spin-off and consulted on local country tax issues that need to be considered, including applicable filing requirements.
- **Foreign asset extraction—**Determine the most tax-efficient way of extracting any assets to be retained by RemainCo, if any, prior to spin-off. An analysis of applicable income, transfer and VAT taxes associated with any transactions should be performed.
- **Foreign earnings and profits—**Perform an analysis of accumulated earnings and profits for each of its foreign subsidiaries. If historical information hasn't been maintained in prior years, responsibility for determining earnings and profits should be negotiated prior to spin-off.
- **Deemed dividend inclusions associated with pre spin-off restructuring—**Even in the context of an otherwise tax-free separation transaction, management should assess through detailed modeling the impact of pre spin-off restructuring transactions to separate SpinCo from RemainCo business involving foreign entities for potential deemed dividend inclusions under various deemed dividend rules. Following US tax reform, dividends received by a US corporation from a 10% or more owned foreign corporation are generally eligible for a 100% deduction. However, because several anti-abuse rules and other limitations under section 245A could apply in specific circumstances to restrict such deduction, the availability of the section 245A deduction to any deemed dividend inclusion amount should be analyzed and confirmed.
- **Base erosion anti-abuse tax (BEAT) position—**The impact of the spin-off on the Parent's BEAT profile should be assessed. BEAT is a minimum taxing provision that applies when certain related party deductible payments reach a certain threshold (i.e., 3% of total deductions, the "base erosion percentage"). Depending on the nature of the operations of the SpinCo and the retained business, key inputs to the BEAT computations (like the base erosion percentage) may be impacted.
- **Global intangible low-taxed income (GILTI) position—**Parent should assess the impact of the spin-off on its GILTI profile. GILTI requires a US corporation to include Controlled Foreign Corporation (CFC) income currently to the extent it exceeds a 10% return on tangible depreciable property. The spin-off transaction may impact the amount of tangible depreciable property in the spin-off business vs. the retained businesses, and therefore the relative GILTI inclusions going forward. Taxable separation transactions may create incremental GILTI in connection with transactions facilitating the spin-off. Further, changes to the assets of the Parent or SpinCo may impact expense allocations to GILTI category income for purposes of the foreign tax credit limitation against GILTI.
- **Foreign tax credit (FTC) position—**The Parent's FTC position must be determined based on its existing operations as well as any anticipated changes. Whether the Parent will receive a full or only a partial FTC is dependent upon the annual amount of foreign source income received from foreign subsidiaries as well as the amount of expense required to be allocated against this income for FTC purposes. The overall impact of the Parent's FTC position will be important in establishing a dividend repatriation strategy and determining the worldwide tax provision. Following US tax reform, there are now several categories of foreign source income that must be considered when analyzing the Parent's foreign source income profile, e.g., general, GILTI and foreign branch categories.



- **Expense allocation/apportionment—**To determine its FTC position, the Parent must review the impact of expense apportionment on foreign source income. Primary expense categories are as follows:
  - **Interest expense—**Depending upon the nature of the Parent's US and foreign entity debt, the allocation of US interest expense to foreign subsidiaries could substantially reduce the ability to claim an FTC on a stand-alone basis. Accordingly, it's critical that you review this area for the current FTC impact and potential planning ideas. In addition, alternative methods for allocating interest expense (e.g., historical cost or fair market value method) should be performed.
  - **Interest expense limitation—**US interest limitation rules introduced in 2018 apply a 30% limitation on earnings before interest, taxes, depreciation and amortization (EBITDA) (through 2022, when the limitation base changes to EBIT) to all interest expenses, where prior rules applied only to related party interest expenses. The Parent and SpinCo's limitation profile should be considered in light of the spin-off when considering the appropriate capital structure.
  - **R&D—**The Parent must determine allocations in view of stand-alone R&D activities.
  - **Other allocations—**The Parent should review state tax and other allocations to subsidiaries relating to expense apportionment, as appropriate.
- **Overall foreign loss (OFL)—**An OFL can substantially reduce the ability to claim an FTC in the future until such time as an OFL is recaptured. Accordingly, the Parent and SpinCo will want to reach an agreement regarding the allocation of the existing OFL, if any. In light of the expanded number of FTC limitation categories in 2018, you should also consider separate limitation losses (SLLs) and the impacts of any allocations.
- **Section 965 installment liability—**The Parent should consider certain elections made as a result of US tax reform, including section 965 (toll charge). Specifically, section 965(h) permits US shareholders that had a toll charge inclusion with respect to specific foreign corporations under section 965 to pay any such liability in several installments over the course of several taxable years. However, because an event such as a spin-off could potentially trigger an acceleration of any remaining installments, the Parent should consider if their spin-off may result in an acceleration event with respect to an outstanding section 965(h) election liability.

Other international tax considerations

Beyond the items noted above, the following additional considerations may be relevant and should be contemplated during the planning process.

- **International expansion—**If the Parent and/or SpinCo plans to expand international operations, Parent will need to develop a comprehensive international tax structure to optimize funding strategy and repatriation planning. Parent should:
  - Develop a tax-efficient repatriation policy to satisfy the need for cash in the US as well as for any overseas expansion. This includes the establishment of a dividend policy as well as royalty, interest expense and management fee policies, as applicable.
  - Review the current worldwide structure to determine if it provides the most tax-efficient structure on a stand-alone basis for future operations, including the possible establishment of a foreign holding company.
  - Consider tax-efficient financing techniques to reduce the worldwide tax burden.
  - Develop a policy regarding the effective use of debt in local countries and consider debt push-down transactions in view of any US Parent leverage resulting from the spin-off.
  - Consider withholding tax implications of current and future structuring activities.
  - Analyze the value of any proprietary technology licensed to foreign subsidiaries to maximize royalty expense in foreign countries with high tax rates.
- **Local country tax planning—**Once a thorough analysis of the Parent and SpinCo's foreign operations on a stand-alone basis has been performed, the level of emphasis on local country tax planning can be determined. The Parent and SpinCo should address the administration and minimization of value-added taxes (and similar taxes) in various foreign jurisdictions as appropriate.
- **Transfer pricing—**Depending upon the level of goods transferred or services performed on behalf of foreign operations, the Parent and SpinCo need to analyze and document its transfer pricing procedures between US and foreign operations. Stringent transfer pricing rules have been established for tax purposes which will need to be addressed on a stand-alone basis.
- **Foreign currency—**Issues related to treasury activities and international operations will need to be reviewed, including:
  - Hedging
  - Hyperinflationary countries, if any
  - Foreign currency translation
- **Expatriate tax services—**The Parent and SpinCo should consider the need to establish an expatriate program for personnel on foreign assignment.

Financial statement impact and reporting considerations

The Parent and SpinCo's tax organizations will have to work closely with the accounting teams to determine the financial statement impact of the spin-off transaction as well as to construct separate company income tax provisions. While there are many detailed aspects to be addressed, some of the important considerations to think through during the planning process are as follows.

- **Effective tax rate—**Financial management must have a strong command of the factors (e.g., mix of worldwide income, state rates, uncertain tax positions policy, foreign taxes, etc.) impacting the effective tax rate so that accurate tax provisions and earnings per share estimates can be made and analyst queries can be responded to confidently. A working model should be constructed which provides management with an understanding of the base effective tax rate and related sensitivities.
- **Uncertain tax positions (UTP)—**It is advisable that SpinCo and the Parent agree on the amount of tax accrual for potential future tax assessments (federal, state and international) for SpinCo to assume as part of its overall debt assumption in the spin-off transaction. This should include identifying areas of specific or potential exposure requiring tax accrual before the spin-off. It will also help avoid uncertainty over who's responsible for payment in the event that future examinations result in payment to the various taxing authorities for issues arising before the spin-off.
- **Tax sharing/indemnification agreement—**SpinCo and the Parent should enter into a written tax sharing and indemnification agreement. The agreement(s) will assist in establishing the tax provision treatment of pre-spin activity and should also specify ownership/liability for tax refunds/assessments for adjustments to prior year taxes as a result of future examinations by various taxing authorities or amended returns.
- **Stand-alone tax provision of SpinCo—**If a detailed tax provision was not maintained for SpinCo during pre-spin periods, then it will be necessary for SpinCo to work with the Parent's tax department personnel to construct stand-alone provisions for inclusion in the pro forma financial statement information in Form 10 (filed with the SEC). SpinCo's management should be made aware of any high level ASC 740 (governing accounting for income taxes) issues identified and the related impact on SpinCo's current and future tax provision.
- **Foreign dividend repatriation—**SpinCo's management must establish a dividend repatriation policy for foreign subsidiaries. If earnings of foreign subsidiaries are to be repatriated to the Parent, then any incremental US taxes, net of foreign tax credits should be recorded in SpinCo's tax provision. If earnings of foreign subsidiaries are considered permanently reinvested, then incremental US taxes are not required to be recorded. Establishing a policy prior to spin is important given the potential impact on SpinCo's pre-spin and post-spin tax provision.

For more information on delivering value on your divestiture and tax structuring, please contact:

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Preparing the registration statement and carve-out financial statements for SpinCo

The challenges of executing a spin-off, both operationally and in compliance with regulatory requirements, cast a wide net across functional areas. Though finance is typically the center from an accountability standpoint, input from key areas of the business is needed throughout the process. There are a number of areas to consider when preparing to file a registration statement; it's important to ensure there is collaboration among all internal and external stakeholders, including SpinCo's auditors and external legal counsel, such that decisions can be made and implemented efficiently.

In this section we cover:

Preparing the registration statement

The determination of which SEC form should be used for registration purposes is a legal determination that should be made by a company in consultation with its securities counsel. Form 10 and Form S-1 are the basic registration forms for spin-offs. Companies may confidentially submit certain registration statements for SEC review, as well as omit audited financial statements (from confidential submissions) for periods that are not reasonably believed to be required at either (i) the time of the initial public filing of the registration statement or (ii) at the time of the contemplated spin-off, depending on SpinCo's eligibility to qualify as an emerging growth company (EGC). Preparing the registration statement involves coordination and discipline amongst several stakeholder groups. The financial information required to be presented in the registration statement varies based on several factors, including SpinCo's filer status and the time it takes to clear SEC comment letters.

Preparing carve-out financial statements

The preparation of carve-out financial statements for spin-offs is complex. You may find that a significant investment in time and resources will be necessary to meet these challenges. With the limited guidance governing preparation of carve-out financial statements, being aware of current practice and methodologies historically accepted by the SEC will help you navigate the carve-out process. This section highlights the accounting challenges, methodologies and areas of judgement you will face when preparing carve-out financial statements.

Preparing the registration statement

Preparing and filing the registration statement is a relatively complicated, time-consuming, technical process requiring substantial planning and coordination. It involves providing the information specified by the SEC form and complying with the applicable SEC rules in the most efficient manner possible. It requires a great deal of effort by the management team, internal and external legal counsel to describe a company as accurately and positively as possible, while also disclosing any negative risk factors.

It is during the preparation process of an initial registration statement that a scheduled timetable for the spin-off can take longer than expected, often causing a delay in the anticipated filing date. It is therefore imperative that the entire team be thoroughly familiar with the registration statement requirements, be cognizant of the deadlines, periodically assess the status of specific sections of the registration statement and ensure that reviews of each section are timely.

We've gathered here the financial statement reporting requirements for SpinCo in its initial registration statement. It's important to plan for each of these items thoroughly and with the right support as the overall transaction timeline is highly sensitive to the SEC filing process.

Below are the critical financial reporting items for you to consider during the planning phase.

- **Determine which form to use, Form 10 or Form S-1—**Depending on the structure of the spin-off, you will need to file a registration statement, typically using a Form 10 or Form S-1. While the appropriate form is a legal determination, that determination generally follows the following framework:
  - If the spin-off involves a pro-rata distribution of SpinCo shares to the Parent's shareholders, the Parent will typically file a Form 10 to file an Exchange Act registration statement. The effect of this transaction is to "dividend-off" or "carve-out" a piece of the company to the Parent's existing shareholders. Thus, SpinCo becomes a stand-alone company with its own equity structure. All references to a Form 10 in this guide refers to the Form 10-12(b). If the spin-off involves the sale of some of the shares of SpinCo first to the public through an initial public offering (IPO), a Form S-1 is filed. Frequently, the offering comprises no greater than a 20% ownership interest in SpinCo; therefore, the Parent retains the ability to spin-off the remaining interest at a later date on a tax-free basis. The tax structure and treatment of the transaction requires careful analysis from internal and external legal counsel. A Form S-1 is used by new companies to register for the first time under the Securities Act of 1933. Both a Form 10 and a Form S-1 include detailed information about SpinCo, including but not limited to its business operations, management team, risk factors, management's discussion and analysis of financial condition and results of operations (MD&A) and stand-alone financial statements, as well as other historical and pro forma financial information.
- **Prepare carve-out financial statements for all required periods—**Carve-out financial statements refer to separate financial statements that are derived or "carved-out" from the financial statements of a larger entity. One of the long-lead time areas of preparing a registration statement is preparing the historical carve-out financial statements for SpinCo. The need for data and numerous judgments by management can be challenging, especially when limited authoritative guidance exists. However, while there is limited authoritative guidance in this area, there are very well understood "practices" with regard to the preparation of the carve-out financial statements and you should ensure that the right experts are engaged to advise on the process.

  The carve-out financial statements should reflect the historical operations of SpinCo on a stand-alone basis. As such, care must be taken to determine that all of the assets and liabilities of the separate business have been properly identified and that all relevant costs of doing business have been reflected. In our experience, factors that impact the timing of the preparation of the carve-out financial statements includes the degree of commingled balances, number of international locations, the availability of auditable historical information (including leverageable historical statutory audits) and the capacity of management's financial reporting team. Management should also be mindful of the legal entity structure of SpinCo, and the interplay of that deal perimeter with the determination of the basis of presentation of the carve-out financial statements. Another factor to consider is the potential for a drastically different materiality level for the SpinCo on a stand-alone basis versus the ParentCo. This may require additional analysis and potentially add time to the audit process.

  For more information, see page 45, *Preparing carve-out financial statements*.

Another area that typically requires a long-lead time is the requirement to present up to five (5) years of selected historical financial data under SEC Regulation S-K Item 301. On November 19th, 2020, the SEC adopted amendments to modernize and enhance Management's Discussion and Analysis and other Financial Disclosures, which eliminated the requirement for registrants to provide five (5) years of selected financial data. Registrants are required to comply with the new rules beginning with the first fiscal year ending on or after August 9, 2021. Registrants may early adopt the amended rules at any time after February 10, 2021 (the effective date) on an item-by-item basis, as long as they provide disclosure responsive to an amended item in its entirety. Refer to PwC's In Depth *SEC Amends MD&A and Eliminates Selected Financial Data* for additional information relating to the amendment.

- **Consider filing confidentially—**The confidential submission and review process allows a company to keep its registration statements confidential until no later than 15 days prior to the anticipated effective date of the registration statement. It will also permit a company to explore alternate paths (e.g., pursuing a strategic or financial buyer) while concurrently preparing for a spin-off. Consistent with all filing reviews, the SEC will publicly release its comment letters and issuer responses no earlier than 20 business days following the effective date of the registration statement. In draft registration statements submitted for confidential review, companies may omit annual and interim financial information that is reasonably believed will not be required to be separately presented at either (i) the time of the contemplated spin-off (if the company is an EGC or (ii) the time of the first public filing of the registration statement (if the company is a non-EGC). However, once a company files publicly (even as an EGC), it will functionally be required to include all required interim periods, even if those periods are not the same periods required to be presented separately as of the contemplated offering[1].

  For example, assume a calendar year-end EGC submits a Form 10 for confidential review in November 2021 and reasonably believes the spin-off will be effective in April 2022, when annual financial information for 2021 will be required to be included (along with annual 2020 and 2019[2]). In its confidential submissions, a company may omit from its draft registration statement the 2018 annual financial information and interim financial information related to 2021 and 2020. If a company were to file publicly in January 2022, it may omit its 2018 annual financial information, as this annual information would not be expected to be required at the time of the effectiveness of the Form 10. However, its year-to-date September 30, 2021 and 2020 interim financial information is required in the public filing in January 2022 based on the age of financial statement rules for public filings.

  Note that the relief offered when filing confidentially is different for an EGC versus a non-EGC for annual periods. EGCs can exclude in confidential submissions the financial statements for annual periods that are not expected to be required at the time of the contemplated offering. A non-EGC determines the requirements for annual periods in its confidential submissions based on the age of financial statement requirements at the time of the initial public filing of the registration statement. Learn more about the filing requirements and related exemptions granted to EGCs below.

[1] See SEC CD&I, Securities Act Forms, questions 101.04 and 101.05.

[2] The EGC exemption to present 2 years of annual audited financial statements does not apply to EGCs filing a Form 10; therefore in this example, 3 years of annual audited financial statements are required for an EGC filing a Form 10.

- **Determine SpinCo's eligibility to qualify as an EGC**—SpinCo's eligibility to qualify as an EGC may impact its reporting requirements, both as SpinCo prepares to go public and in the future when SpinCo is a public company. It is critical to understand all relevant criteria underpinning a particular status, as well as the ongoing requirements to maintain that status. Below we discuss the relevant criteria for qualifying as an EGC, as well as the relief provided to EGCs, and the criteria for qualifying as a Foreign Private Issue (FPI) and resulting reporting requirements.

  Emerging growth companies

  In recent years the SEC has exhibited a keen focus on facilitating capital formation, which has been evidenced through a variety of rulemaking activities. The JOBS Act of 2012 created special accommodations under US securities laws for EGCs. The principal goal of the JOBS Act was to encourage private companies to raise capital through an IPO of their common equity. The JOBS Act was initially contemplated in March 2011 when it was determined that a long-term decline in US IPOs could result in a loss of up to 22 million American jobs. The JOBS Act has made it easier for qualifying companies to go public by simplifying the public registration process and ongoing SEC reporting requirements.

  The JOBS Act reduces the filing and disclosure burdens associated with undertaking a public registration and provides companies with easier and broader access to the capital markets. Both domestic issuers and FPIs can qualify to be EGCs.

  EGC qualifications

  SpinCo qualifies as an EGC if it has total annual gross revenues of less than $1.07 billion during its most recent fiscal year (the amount is indexed for inflation every five years). SpinCo retains its EGC status until it triggers one of the disqualifying provisions below:

  – The last day of the fiscal year in which it had total annual gross revenues of $1.07 billion or more
  – The last day of the fiscal year following the fifth anniversary of the date of the first sale of the SpinCo's common equity securities, under an effective Securities Act Registration Statement as an EGC.
  – The day when SpinCo has issued more than $1 billion in non-convertible debt securities over the previous three years
  – The date on which SpinCo becomes a large accelerated filer. SpinCo would qualify as a large accelerated filer when the aggregate worldwide market value of its voting and non-voting common equity held by non-affiliates (public float) is at least $700 million as of the last business day of its most recently completed second fiscal quarter. Note that the determination of whether a company is a large accelerated filer is made on the last day of the company's fiscal year.

  While you may qualify as an EGC, it's best to consult with external legal counsel in making this determination.

Foreign private issuers

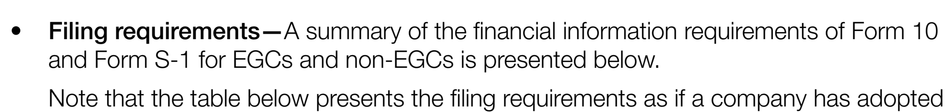
If SpinCo qualifies as an FPI, it could qualify for several areas of relief. Under securities law, a foreign issuer is a foreign government, any foreign national, or a corporation or other organization incorporated or organized under the laws of any foreign country. An FPI is any foreign issuer (other than a foreign government), unless:

- More than 50% of the issuer's outstanding voting securities are held directly or indirectly of record by residents of the US and any of the following:
  - The majority of SpinCo's executive officers or directors are US citizens or residents
  - More than 50% of SpinCo's assets are located in the US
  - SpinCo's business is administered principally in the US

A foreign company that qualifies as an FPI has certain benefits, including the following:

- Required to file annual reports up to four months after year-end
- No interim reporting requirements on Form 10-Q. Permitted to file using either (i) foreign accounting principles, provided material differences are reconciled to US GAAP or (ii) IFRS as issued by the International Accounting Standards Board (IASB)
  - Not subject to SEC proxy rules or executive compensation disclosures under S-K Item 402 and Regulation FD

While you may qualify as an FPI, it's best to consult with external legal counsel in making this determination.



- **Filing requirements—**A summary of the financial information requirements of Form 10 and Form S-1 for EGCs and non-EGCs is presented below.

  Note that the table below presents the filing requirements as if a company has adopted both of the amended rules below:

  1. The SEC's amended disclosure requirements applicable to acquisitions and dispositions of businesses, including real estate operations and investment companies issued in May 2020. Refer to PwC's In Depth *SEC Amends Disclosure Rules for Acquired and Disposed Businesses* for additional details regarding the amended rules.

     The amended disclosure requirements reduced the maximum number of years for which audited financial statements are required under Rule 3-05 of Regulation (S-X Rule 3-05) for significant acquisitions from three years to two years. It also eliminated the requirement to provide financial statements for a comparative interim period when only one year of audited financial statements is required under S-X Rule 3-05. This is a significant change and eliminates certain provisions that required financial statements for older significant acquisitions to be included in filings such as Form 10 and Form S-1. Registrants will be required to apply the new rules no later than the beginning of the registrant's fiscal year beginning after December 31, 2020 (the mandatory compliance date). Voluntary early compliance is generally permitted immediately provided that the new rules are applied in their entirety from the date of early compliance.

     Registrants and their advisors should refer to Section II.F. of Release 33-10786 for additional information relating to transition.

  2. The SEC's amendments to modernize and enhance Management's Discussion and Analysis and other Financial Disclosures released on November 19, 2020 eliminated the requirement for registrants to provide five (5) years of selected financial data. Refer to PwC's In Depth *SEC Amends MD&A and Eliminates Selected Financial Data* for additional information relating to transition.

     The SEC's adopting release encourages registrants to consider:

     - Whether trend information for periods earlier than those presented in the financial statements may be necessary as part of the MD&A's objective "to provide material information relevant to an assessment of the financial condition and results of operations"
     - Whether a tabular presentation of relevant financial or other information, as part of an introductory section or overview, may be appropriate to demonstrate material trends

     In addition to acknowledging that historical information is readily available, the rule change will also substantially reduce or eliminate challenges that registrants may have encountered when, for example, preparing the tabular disclosures following a disposition treated as discontinued operations and other events requiring retrospective revisions to historical financial statements.

     The amended rules were posted to the Federal Register on January 11, 2021 and became effective on February 10, 2021. Registrants are required to comply with the new rules beginning with the first fiscal year ending on or after August 9, 2021. Registrants may early adopt the amended rules at any time after the effective date (on an item-by-item basis), as long as they provide disclosure responsive to an amended item in its entirety.

	Non-EGC	EGC
Form 10 submission	Companies can generally submit a registration statement for SEC review on a confidential basis provided that the Company will publicly file its registration statement at least 15 calendar days prior to the requested effective date of the registration statement	
Form S-1 submission	Companies can submit a registration statement for SEC review on a confidential basis up until 15 calendar days before a company's roadshow	
Annual audited financial statements in an effective Form 10 Filing	Balance Sheet—**2 years** Statements of operations, cash flows and shareholder's equity—**3 years**	
Annual audited financial statements in an effective Form S-1 Filing	Balance Sheet—**2 years** Statements of operations, cash flows and shareholder's equity—**3 years**	Balance Sheet—**2 years** Statements of operations, cash flows and shareholder's equity—**2 years**
Annual audited financial information in a pre-effective Form 10/ Form S-1 filing **Selected financial information in a pre-effective Form 10/ Form S-1 filing (*/**)**	A non-EGC may omit financial statements that it reasonably believes will not be required at the time the registration statement is publicly filed	An EGC may omit financial statements that it reasonably believes will not be required at the time of the contemplated offering
Interim financial statements in a confidential Form 10/Form S-1 filing	A non-EGC may omit interim financial information that it reasonably believes will not be required at the time the registration statement is publicly filed based upon age of financial statement requirements	An EGC may omit interim financial information that it reasonably believes will not be required at the time of the contemplated offering; however, EGCs must include applicable interim information at the time the registration statement is publicly filed based upon age of financial statement requirements
Selected financial information in an effective Form 10/Form S-1 filing (*/)**	SEC amendment eliminated the requirement to present (5 years)	SEC amendment eliminated the requirement to present 2 or 3 years depending upon Securities Act or Exchange Act registration statement, respectively
MD&A (**)	Required for periods matching the audited financial statements and interim financial statements included in the registration statement	

	Non-EGC	EGC
Audited financial statements of an acquired business in Form 10/Form S-1 filing (***)	20% significance: one (1) year of audited financial statements of the acquired business and current year-to-date interim period 40% significance or more: two (2) years of audited financial statements of the acquired business and current and corresponding prior year year-to-date interim periods A non-EGC in its confidential and/or public filing may omit financial statements that it reasonably believes will not be required at the time the registration statement is publicly filed An EGC in its confidential submission may omit financial statements that it reasonably believes will not be required at the time of the contemplated offering	
Effective date and transition of new accounting standards	A SpinCo preparing an SEC filing generally must apply all accounting standards as if it had always been a public company	A SpinCo EGC may elect to apply new or revised financial accounting standards on the same date that a company that is not an issuer is required to apply the new or revised accounting standard
	Refer to PwC's In Depth *How to Apply the FASB's Deferral of Effective Dates* for additional information regarding specific adoption of new accounting standards	
Management assessment of internal control SOX 404(a)	Management's assessment on internal controls over financial reporting in second Form 10-K filing	
Auditor attestation on internal control SOX 404(b)	Auditor's attestation on internal controls over financial reporting in second Form 10-K filing (applicable for accelerated and large accelerated filers)	Not required for as long as the company is an EGC
Executive compensation disclosures (CD&A) (*)	Provide full compensation disclosures (e.g., compensation tables for top 5 executives for 3 years) Shareholders' voting on "say on pay" and "golden parachute" compensation disclosures are required	EGCs are allowed to follow reporting obligations of smaller reporting companies (e.g., compensation tables for top 3 executives for 1 year within the Form S-1) EGCs are exempt from a full CD&A disclosure incl. the shareholders' voting on "say on pay" and "golden parachute" compensation disclosures

* This exemption does not apply to EGCs that are filing a Form 10 under the Exchange Act.

** On November 19, 2020, the SEC issued an amendment to modernize, simplify, and enhance Management's Discussion and Analysis (MD&A), streamline supplementary financial information, and eliminate the requirement to provide certain selected financial data. Key changes of the amendment also include:

- enhancements and clarification of the disclosure requirements for liquidity and capital resources;
- elimination of five years of Selected Financial Data;
- replacement of the current requirement for two years of quarterly tabular disclosure with a principles-based requirement to provide information only when there are material retrospective changes;
- codification of prior SEC guidance on critical accounting estimates;
- elimination of the tabular disclosure of contractual obligations; and
- conforming amendments for foreign private issuers.

For further information, refer to PwC's In Depth *SEC Amends MD&A and Eliminates Selected Financial Data.*

*** In May 2020, the SEC amended its disclosure requirements applicable to acquisitions and dispositions of businesses, including real estate operations and investment companies. The amended S-X Rule 3-05(b)(2) reduced the maximum number of years for which audited financial statements are required under S-X Rule 3-05 from three years to two years. It also eliminated the requirement to provide financial statements for a comparative interim period when only one year of audited financial statements is required under S-X Rule 3-05.

Additionally, amended S-X Rule 3-05(b)(4) permits the omission of separate acquired business financial statements once the business has been included in the registrant's post-acquisition audited annual financial statements for either nine months or a complete fiscal year, depending on the level of significance.

This is a significant change and eliminates certain provisions that required financial statements for older significant acquisitions to be included in filings such as Form S-1. In adopting these changes, the SEC highlighted the pre-existing provisions of S-X Rule 4-01(a), which requires that a registrant provide "such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

Registrants will be required to apply the new rules no later than the beginning of the registrant's fiscal year beginning after December 31, 2020 (the mandatory compliance date). Voluntary early compliance is generally permitted immediately provided that the new rules are applied in their entirety from the date of early compliance. Registrants and their advisors should refer to Section II.F. of Release 33-10786 for additional information relating to transition.

Refer to PwC's In Depth *SEC Amends Disclosure Rules for Acquired and Disposed Businesses* for additional details regarding the amended rules.

- **Interim financial statement considerations—**SpinCo is required to submit interim financial statements (with comparative prior period) in public filings in accordance with the requirement to comply with the SEC's age of financial statements rules. Interim financial statements are required if the fiscal year-end financial statements are more than 134 days old, except for third-quarter financial statements, which are timely through the 45th day after the most recent fiscal year end. After the 45th day, audited financial statements for the fiscal year must be included. Interim financial statements can be presented in a condensed format and generally are not audited for domestic filers. However, a review of the interim financial statements is typically performed by independent auditors.

  There are exceptions for FPIs and confidential filings.

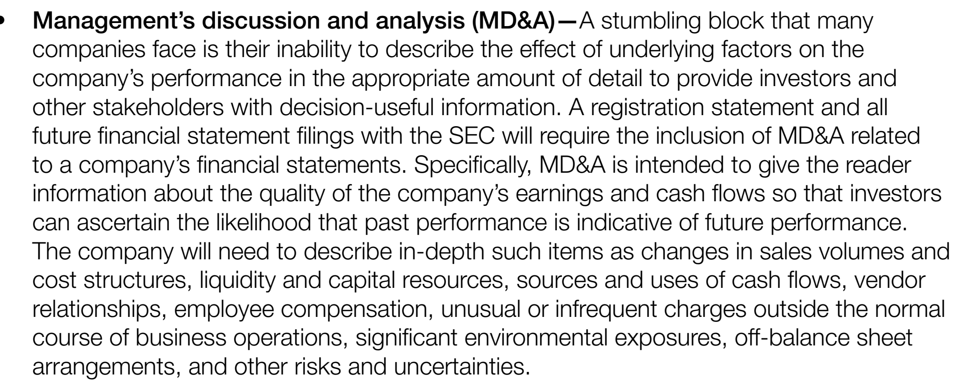
  - **FPIs—**FPIs can omit interim unaudited financial statements if the registration statement becomes effective within nine months of the last audited financial statement period within their registration statement. After that time, an FPI must provide interim financial statements (which may be unaudited) covering at least the first six months of the fiscal year, together with comparative financial statements for the same period in the prior year.
  - **Confidential filings—**In draft registration statements submitted for confidential review, non-EGCs may omit interim financial information that is reasonably believed will not be required to be separately presented at the public filing of the registration statement; whereas an EGC may omit interim financial information that is reasonably believed will not be required at the time of the contemplated offering. However, once a company files publicly (even if it is an EGC), it will need to include all required interim periods, even if those periods are not the same periods required to be presented separately as of the contemplated offering.

- **Risk factors—**Included in the non-financial part of a registration statement. Regulation S-K requires companies to disclose all known significant factors that pose a risk applicable to the organization, its macroeconomic environment or its securities. Common categories of risk include industry risks, company risks and investment risks. Risk factors should be specific to the company and described in clearly understandable language.

  The SEC amended its disclosure requirements relating to risk factors. Previously, registrants were required to include a discussion of the "most significant" factors that make an investment in the registrant or the offering speculative or risky. The amended disclosure requirements were effective on November 9, 2020. The amendments update the disclosure threshold to refer to "material factors" and among other rules, requires that if the discussion exceeds 15 pages, the registrant must provide a series of concise bulleted or numbered statements that is no more than two pages summarizing the principal factors. For more information on the amendments to the requirements related to disclosures around risk factors, refer to PwC's In Depth *Navigating the SEC's Amended Regulation S-K Disclosure Rules*.

  Typical areas of SEC comment include:

  - Removal of risks that could apply to any issuer in the same industry
  - Removal of any disclosure implying that there are other material risks that are not described in the filing
  - Expanded disclosure for EGCs relating to the risk of a lack of comparability of financial statements and reduced reporting requirements
  - Additional information regarding any material weakness or significant deficiency in the SpinCo's internal control environment and related financial reporting impacts
  - Description of the nature, severity and frequency of any data breaches



- **Management's discussion and analysis (MD&A)—**A stumbling block that many companies face is their inability to describe the effect of underlying factors on the company's performance in the appropriate amount of detail to provide investors and other stakeholders with decision-useful information. A registration statement and all future financial statement filings with the SEC will require the inclusion of MD&A related to a company's financial statements. Specifically, MD&A is intended to give the reader information about the quality of the company's earnings and cash flows so that investors can ascertain the likelihood that past performance is indicative of future performance. The company will need to describe in-depth such items as changes in sales volumes and cost structures, liquidity and capital resources, sources and uses of cash flows, vendor relationships, employee compensation, unusual or infrequent charges outside the normal course of business operations, significant environmental exposures, off-balance sheet arrangements, and other risks and uncertainties.

  On November 19, 2020, the SEC amended its MD&A requirements, which were significantly restructured and streamlined using a principles-based approach intended to improve its usability and enhance disclosures for investors while reducing compliance burdens for registrants. The amendments are intended to remind registrants that MD&A should provide analysis that encompasses short-term results as well as future prospects. Registrants should consider only disclosing the information that is necessary to understand the business and its financial condition, changes in financial condition, and results of operations. In addition, MD&A should not duplicate the disclosures that have been included elsewhere; the discussion is intended to be additive and limit repetition if the underlying reasons for a change impacts multiple line items.

  - The amendments clarify that the objective of MD&A is to facilitate a discussion and analysis of material information, events, and factors specific to a registrant's business and to enable investors to understand the business and results from "management's perspective." This is a guiding principle that is to be applied throughout the MD&A with a focus on material events and uncertainties known to management. In addition, registrants should provide a discussion of forward-looking perspectives and must include disclosure of matters that management believes are reasonably likely to have a material impact on future operations.
  - Registrants should focus on what is necessary to understand the business, results, and material changes. Disclosures should continue to include qualitative and quantitative discussion of material changes and the underlying drivers of the changes from period-to-period in one or more line items even when material changes within a line item offset each other.
  - The amendments also codify existing SEC guidance and require the discussion to focus on each reportable segment and/or other subdivision, if necessary to an understanding of the business. The new amendments add product lines as an example of this disaggregated analysis where the existing rules have only geographic region as an example.

  For further information, refer to PwC's In Depth *SEC Amends MD&A and Eliminates Selected Financial Data* for additional information relating to the amendments.

  As a company completes its annual and quarterly financial statements, it should take time to write its MD&A. If the MD&A is not drafted in a timeframe near the preparation of the financial statements, preparers often struggle with obtaining the level of detailed information to provide a robust analysis for users of the registration statement. The practice of writing a high quality, comprehensive MD&A will expedite a company's registration process and be a major step toward reporting like a public company. The SEC comment letter process has reinforced the well-established MD&A objectives that disclosures should be transparent in providing relevant information, tailored to the company's facts and circumstances, consistent with the financial statements and other public communications and comprehensive in addressing the many business risks that exist in today's economic environment.

Typical areas of SEC comment:

- Explanation of the underlying specific drivers behind changes in financial position, results of operations and cash flows
- Reasons for and specifically quantifying significant underlying variances, even when they offset each other
- Discussion and quantification of the impact of pricing and volume changes on results of operations
- Material known trends that may positively or negatively impact future results of operations and liquidity
- Quantified impact of foreign currency fluctuations on revenues, expenses and margins
- Quantified impact of acquired or disposed businesses on results of operations
- Discussion of known trends, events or uncertainties that are reasonably likely to impact future liquidity
- Further disclosure of sources and uses of cash and drivers of cash flows as opposed to repeating what can already be found on the face of the cash flow statement itself
- Description of the covenants in the company's debt agreements and an indication regarding compliance

- **Compensation discussion and analysis (CD&A)—**The CD&A addresses the objectives and implementation of executive compensation programs, focusing on the most important factors underlying the company's compensation policies and decisions. It also addresses why each compensation program element was chosen, how award levels were determined and how each element fits into the company's overall compensation objectives. EGCs are required to follow Smaller company reporting rules, which provide relief regarding compliance with CD&A requirements. Recent changes to proxy requirements require a disclosure of how risk is related to compensation and whether or not these risks may have a material effect on a company. The focus is on how the compensation structures and practices drive an executive's risk-taking and the compensation committee's management of risk related to its compensation program. The changes are meant to increase disclosure of the relationship between a company's overall compensation policies and how these policies create incentives that can affect the company's risk and the management of that risk. Public companies are required to discuss and analyze in the CD&A the risk attributes of their broader compensation policies for employees (including non-executive officers).

  Typical areas of SEC comment:

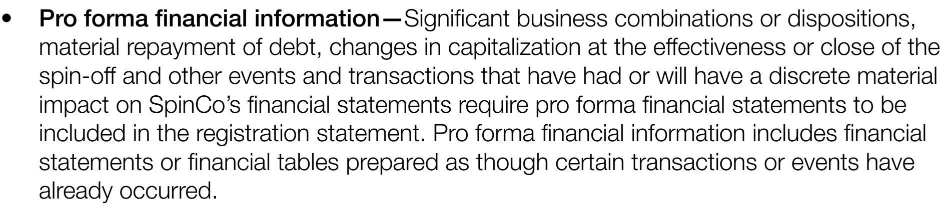
  - Basis for omitting incentive plan performance targets and disclosure regarding the relative likelihood that those performance targets will be met—omission of such information is usually met with scrutiny from the SEC Staff
  - Description of incentive plan performance targets
  - Identification of other companies used for benchmarking purposes
  - Description of the roles and responsibilities that the CEO, compensation consultants and compensation committee had in the executive compensation decision making process

- **Non-GAAP financial measures:** As you plan for your spin-off, one of many choices to be made is how or if SpinCo should disclose non-GAAP financial measures in its filings. Use of non-GAAP measures, which often mirror key performance or liquidity metrics used by senior management in running the business, may allow companies to highlight key facts and circumstances to the investment community and facilitate comparability with their peers. However, while non-GAAP measures can be a key tool during a spin-off, companies should carefully consider the costs and benefits associated with their use. The SEC typically closely reviews the basis of calculation, level of disclosure and description of the metric, including why it is useful and how management uses the measure for internal purposes. The investment community will expect consistent presentation of the non-GAAP measures from period to period, both during and following the spin-off. If a change is made to the definition of such measures, robust disclosure of the reason for the change, the impact of the change, and oftentimes, recast prior period information is requested. Thus, appropriately identifying these items early in the spin planning process is critical. In a worst case scenario, improper usage or disclosure of non-GAAP measures can lead to unanticipated costs and delay the company's spin-off timeline due to regulatory review or confusion caused for potential investors.

  Companies often present certain quantitative measures of past performance, financial position or cash flows that make various adjustments (inclusions or exclusions) to measures reported in the GAAP financial statements. Such non-GAAP measures are permitted to be included in registration statements, as long as they meet the requirements of Regulation G and Item 10(e) of Regulation S-K. Examples of common non-GAAP measures can include adjusted earnings before interest, taxes, depreciation and amortization (EBITDA) and free cash flows.

  Typical areas of SEC comment:

  - Equal or greater prominence given to non-GAAP measures relative to the equivalent GAAP measure
  - Reasons why management believes non-GAAP measures provide useful information to investors
  - Items in the reconciliation of non-GAAP measures to the most comparable GAAP measure
  - Labeling of items as non-recurring, infrequent or unusual when a similar item has occurred in the prior two years and/or is reasonably likely to occur again within the next two years
  - Labeling non-GAAP measures as "pro forma" when they do not comply with the provisions of Article 11 of Regulation S-X
  - Use of 'tailored' accounting principles that are not in accordance with GAAP
  - Determination of a non-GAAP measure as a performance or liquidity measure, which could impact the GAAP starting point of the reconciliation (net income vs. operating cash flows)



- **Pro forma financial information**—Significant business combinations or dispositions, material repayment of debt, changes in capitalization at the effectiveness or close of the spin-off and other events and transactions that have had or will have a discrete material impact on SpinCo's financial statements require pro forma financial statements to be included in the registration statement. Pro forma financial information includes financial statements or financial tables prepared as though certain transactions or events have already occurred.
  - Pro forma financial information should be presented for the most recent balance sheet and for the most recent annual and year-to-date interim income statement. Footnote disclosures for pro forma adjustments for the income statement and balance sheet are also required.
  - The objective of pro forma financial information is to provide investors with an understanding of the impact of particular transactions by indicating how they might have affected the historical balance sheet and income statement had they occurred at an earlier date.
  - The disclosure requirements applicable to acquisitions and dispositions of business, including real estate operations and investment companies were amended by the SEC in May 2020. Refer to PwC's In Depth *SEC Amends Disclosure Rules for Acquired and Disposed Businesses* for additional details regarding the amended rules. Registrants will be required to apply the new rules no later than the beginning of the registrant's fiscal year beginning after December 31, 2020 (the mandatory compliance date). Voluntary early compliance is generally permitted immediately provided that the new rules are applied in their entirety from the date of early compliance. Certain amendments replace the pre-existing pro forma adjustment criteria with the following three categories of adjustments:
    - **Transaction accounting adjustments** to reflect only the application of required accounting for the transaction, such as purchase accounting
    - **Autonomous entity adjustments** to reflect the operations and financial position of the registrant as an autonomous entity if the registrant was previously part of another entity, such as a spin-off transaction in which the costs allocated to the entity do not reflect all of the expected costs of operating as a standalone public company
    - **Management's adjustments** which may depict synergies and dis-synergies of an acquisition or disposition, or give effect to other items for which management determines to warrant disclosure in the context of a merger or disposition. These management adjustments are voluntary in nature and are not permitted to be presented on the face of the pro forma balance sheet or income statement(s), but rather in a footnote disclosure to the pro forma financial information.

    Transaction accounting and autonomous entity adjustments are required when the conditions for their presentation are met. Transaction accounting adjustments are presented in accordance with the relevant GAAP that would apply to such items, such as the accounting for business combinations under ASC 805. Autonomous entity adjustments must be presented in a separate column from transaction accounting adjustments.

    Below is a list of illustrative autonomous entity adjustments to consider related to a spin-off:

    - Incremental costs that SpinCo will take on as a stand-alone company
    - Changes in SpinCo's cost structure from service agreements with the Parent
    - Exclusion/inclusion of net assets being spun-off if included/excluded from historical financial statements
    - Indemnification, royalty and operating agreements, if applicable

Management's adjustments are optional and may be presented only in the notes to the pro forma financial statements at the discretion of management if, in management's opinion, they enhance an understanding of the pro forma effects of the transaction and certain conditions are met. These conditions include that:

- There is a reasonable basis for each adjustment.
- The adjustments are limited to the effect of the synergies and dis-synergies on the historical financial statements that form the basis for the pro forma statement of comprehensive income as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented. If the adjustments reduce expenses, the reduction cannot exceed the amount of the related expense historically incurred during the pro forma period presented.
- The pro forma financial information reflects all of management's adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information presented and a statement to that effect is disclosed. When synergies are presented, any related dis-synergies must also be presented.

There are also a number of other presentation requirements, including specified reconciliations and disclosure of the basis for material assumptions or uncertainties. Additionally, other amendments indicate that management's adjustments may need to be updated when included or incorporated by reference in certain registration statements, proxy statements, offering statements or a Form 8-K. Finally, another component of the new rule includes an instruction indicating that any forward-looking information supplied is expressly covered by the safe harbor provisions of Securities Act Rule 175 and Exchange Act Rule 3b-6.

- **Assess need for additional audited financial statements for certain specified entities—**Another area that requires advance planning is assessing whether the registration statement will require separate financial statements or other financial information related to certain specified entities such as significant businesses acquired or to be acquired (S-X Rule 3-05), certain equity method investments (S-X Rule 3-09), guarantors of public debt securities (S-X Rule 3-10)[4] and affiliates whose securities collateralize a registered debt issuance (S-X Rule 3-16)[4]. This separate financial information must also comply with SEC rules and guidance on form and content (Regulation S-X), although a non-public entity whose financial information falls into the scope of these rules would not need to include certain public company disclosures, such as segment information, certain pension disclosures and earnings per share (EPS).

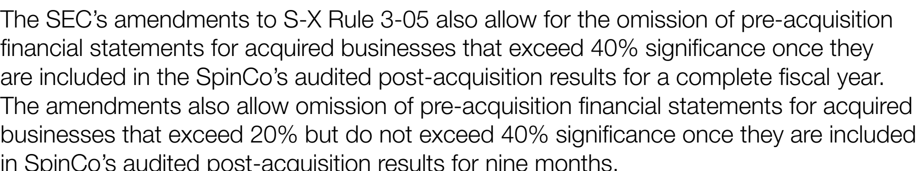
  Although there is some relief for inclusion in a pre-effective filing, obtaining separate audited financial statements or other financial information that might be required by S-X Rules 3-05, 3-09, 3-10 or 3-16 can often be a difficult and costly task and could potentially delay the spin-off. Further, separate financial statements for any non-US entities may require a US GAAP reconciliation if the financial statements are not prepared in accordance with IFRS as issued by the IASB. Pursuant to Rule 3-13 of Regulation S-X, companies may request the SEC's consideration to waive requirements for certain financial statements depending on specific facts and circumstances.

  Reporting requirements for significant acquisitions

  In addition to the SEC amendments discussed above for pro forma financial statements, the SEC also amended its disclosure requirements applicable to acquisitions and dispositions of businesses, including real estate operations and investment companies. Under the amendments, if SpinCo had acquired other businesses in the most recently completed audited fiscal year, this may trigger incremental reporting requirements under S-X Rule 3-05.

  There's a sliding scale to determine the number of years of audited financial information a company needs to present for the acquired business. The degree of significance is measured from S-X Rule 1-02(w) through the income/revenue, asset and investment tests as depicted in the amended rules. An acquired business which is significant (as defined by Regulation S-X) above the 20% and 40% significance levels require one or two years of audited financial statements, respectively, as well as related unaudited interim financial statements (potentially on a comparative basis), depending upon the level of significance and timing of filing by the SpinCo.

[4] In March 2020 the SEC adopted significant changes to its disclosure requirements relating to Financial Disclosures about Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities. The new and amended rules become effective January 4, 2021, subject to voluntary early compliance and the transition provisions described in Section VI of Release 33-10762. Refer to PwC's In Depth *SEC Streamlines Debt Securities Disclosure Framework* for more details.



The SEC's amendments to S-X Rule 3-05 also allow for the omission of pre-acquisition financial statements for acquired businesses that exceed 40% significance once they are included in the SpinCo's audited post-acquisition results for a complete fiscal year. The amendments also allow omission of pre-acquisition financial statements for acquired businesses that exceed 20% but do not exceed 40% significance once they are included in SpinCo's audited post-acquisition results for nine months.

Registrants will be required to apply the amended rules no later than the beginning of the registrant's fiscal year beginning after December 31, 2020 (the mandatory compliance date). For more information on the amended rules, refer to PwC's In Depth *SEC Amended Disclosure Rules for Acquired and Disposed Businesses*.

Abbreviated or special purpose financial statements of an acquired business

In certain instances, the SEC staff may accept less than complete financial statements (e.g., statements of revenues and direct expenses together with statements of assets acquired and liabilities assumed) in lieu of the full financial statements or "carve-out" financial statements required by S-X Rule 3-05. These types of statements are generally considered special purpose financial presentations or "abbreviated" financial statements. The SEC's amendments to S-X Rule 3-05 permits registrants to provide abbreviated financials for all required periods if the acquired business meets certain qualifying and presentation conditions, specifically:

- The total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20% or less of such corresponding amounts of the seller and its subsidiaries consolidated as of and for the most recently completed fiscal year.
- The acquired business was not a separate entity, subsidiary, operating segment (as defined in US GAAP or IFRS-IASB, as applicable), or division during the periods for which the acquired business financial statements would be required.
- Separate financial statements for the business have not previously been prepared.
- The seller has not maintained the distinct and separate accounts necessary to present financial statements that include the omitted expenses and it is impracticable to prepare such financial statements.

The SEC did not address acquisitions of businesses that exceed 20% of the seller's total assets or total revenues. Additionally, they did not address "carve-out" financial statements, noting that "… because issues relating to carve-out financial statements may require unique judgments that involve the balance between investor protection and capital access, we believe questions relating to carve-out financial statements are best addressed on the basis of their unique facts and circumstances through the staff consultation process" (footnote omitted). If the above conditions are met, the amendments to S-X Rule 3-05 provides various presentation requirements for the statement of revenues and direct expenses including which expenses must be included and which may be omitted. The notes to the financial statements must also include additional disclosures, such as:

- A description of the type of omitted expenses and the reason why they are excluded from the financial statements
- An explanation of the impracticability of preparing financial statements that include the omitted expenses
- A description of how the financial statements presented are not indicative of the financial condition or results of operations of the acquired business going forward because of the omitted expenses
- Information about the business's operating, investing, and financing cash flows, to the extent available.

Useful Tip: Asking for an exemption—In certain circumstances, a company can ask the SEC to waive the requirement to include the financial statements for a significant acquisition.

Companies should speak to their legal counsel about the appropriateness of obtaining a waiver from the SEC under Rule 3-13 of Regulation S-X, as discussed above.

Calculating insignificant acquisitions

If the aggregate impact of acquired or to be acquired businesses since the date of the registrant's most recent audited balance sheet for which financial statements are not (or not yet) required to be filed exceeds 50%, the amendments to S-X Rule 3-05 require pre-acquisition financial statements for the most recent fiscal year and the most recent interim period for those acquired or to be acquired businesses that individually exceed 20% significance. Additionally, the amendments to S-X Rule 3-05(b)(2)(iv)(A) require pro forma financial information that depicts the aggregate impact of all acquired or to be acquired businesses or real estate operations, in all material respects. This may require pro forma financial information relating to acquired or to be acquired businesses that are individually insignificant.

Consistent with the pre-existing rules, the disclosure requirements relating to the aggregate effect of acquisitions for which financial statements are not (or not yet) required are applicable to certain registration statements and proxy statements. Separate requirements apply to Item 2.01, Completion of acquisition or disposition of assets, of Form 8-K

Reporting significant equity method investments

SpinCo is required to include separate annual financial statements of its equity method investees if certain significance thresholds are met for any of the fiscal years required to be presented in the filing. Significance should be measured using the investment and income tests described in S-X Rule 1-02(w). The annual financial statements of the equity method investee are required to be audited if the income or investment test exceed 20% significance. If an equity-method investee triggers the requirements for audited financial statements for any period presented in the registration statement, all three years must be presented. However, only the year(s) that triggered the significance threshold for S-X Rule 3-09 require audited financial statements for the investee. Separate interim financial statements are not required for significant equity method investments under S-X 3-09, however, certain summarized interim income statement information may be required of the investee if it is significant per S-X Rule 10-01(b)(1).

SpinCo is also required to provide summarized income statement and balance sheet information of its equity method investees in the notes to its annual financial statements pursuant to S-X Rule 4-08(g) if the significance test thresholds of S-X Rule 1-02(w) are triggered for any of the three significance tests. The significance threshold for inclusion of the annual summary information is 10% (S-X Rule 4-08(g)).

S-X Rule 4-08(g) requires summarized financial information in the notes to the financial statements if any one of the three significant subsidiary tests outlined in S-X Rule 1-02(w) is met when equity method investees are considered individually or grouping any combination of investees. S-X Rule 4-08(g) requires SpinCo's financial statement footnotes to include the following information for all years if the significance thresholds are exceeded.

- Current and non-current assets and liabilities
- Redeemable stock and non-controlling interest
- Revenues
- Gross profit
- Income from continuing operations
- Net income

If the company has already provided separate financial statements of significant investees in a registration statement (per S-X Rule 3-09), our interpretation is that such information need not also be included on an aggregate basis in the Company's disclosures pursuant to S-X Rule 4-08(g).

Filing the registration statement and the SEC review process

When the registration statement has been completed, the document, including exhibits, is filed with the SEC by electronic transmission through EDGAR. Once filed with the SEC, registration statements are processed and reviewed by the staff of the SEC's Division of Corporation Finance, generally consisting of an attorney, an accountant and a financial analyst.

The SEC generally takes 30 days to perform the initial review and provide comments on the registration statement. This may involve consultation with other SEC Staff familiar with a particular industry (such as mining or petroleum engineers). The SEC Staff reviews the documents to determine whether there is full and fair disclosure, particularly to determine whether or not the document contains misstatements or omissions of material facts. The SEC Staff review, however, cannot be relied upon as assurance over the accuracy or completeness of the data.

The review of financial data is performed by a Staff Accountant who reads the entire registration statement to become familiar with the SpinCo and its business. The Staff Accountant may also refer to published annual and interim reports, the Parent's website, newspaper articles and the internet for other publicly-available information regarding the company and its industry. Its purpose is to determine whether the disclosures comply with GAAP and SEC regulations and all applicable authoritative accounting literature, as well as with various SEC staff interpretations and policies dealing with accounting and auditing issues.

If a filing is selected for review, it can entail a full legal and accounting review, a full accounting review or a targeted review. Sarbanes-Oxley requires that once the SpinCo becomes a registrant, its Exchange Act filings will be reviewed no less than once every three years.

Maintaining open communication with the SEC Staff serves to expedite the registration process. Company counsel generally maintains close contact with the SEC Staff while the registration statement is being reviewed.

At the time the document is submitted, the registration statement should be substantially complete, and the age requirements of the financial statements included should be met. SEC Staff occasionally receive incomplete registration statements in an attempt to "get in line" for the review process but will generally not review incomplete registration statements (other than in relation to specific accommodations granted by the SEC in regards to omission of certain financial statements). However, the nature of the omitted sections of the document should be assessed in this regard. If a registrant believes there are extenuating circumstances and the Staff should review an incomplete filing, the matter should be approved by the staff prior to submission.

Useful Tip: If a company has any new or unusual accounting or disclosure issues, obtaining SEC pre-clearance before filing a registration statement can save considerable time and expense. Oftentimes, discussions with the SEC on a pre-filing basis allows for companies and their advisors to address any unusual matters. This process allows registrants to avoid time consuming correspondence with the SEC later in the process and possible re-work if a disagreement exists.

Responding to SEC comment letters and preparing the amended registration statement

After review of the registration statement, the SEC staff typically issues a comment letter that sets forth questions, possible deficiencies and suggested revisions. Submission of a carefully prepared registration statement usually limits Staff comments. While differences of opinion sometimes exist as to the propriety of a particular comment or request, most comments and suggestions made by the Staff are constructive and seek to increase the decision-usefulness of such disclosures.

Each comment in the Staff's letter must be addressed and resolved in writing before the registration statement can become effective. Companies should ensure they provide well thought out responses to SEC comment letters, keeping in mind that the responses will be released to the public after effectiveness. If revisions are necessary, they are made in an amended registration statement that is also filed via EDGAR. After the filing is effective, the comment letters and the company's responses including those exchanged during the confidential portion of the review process are made publicly available via EDGAR.

In addition, significant developments impacting business operations often occur during the period subsequent to filing the initial registration statement and prior to final SEC approval and these must be reported. If a development is materially adverse, it could affect the offering's attractiveness to investors depending upon the level of impact. Conversely, a positive development, such as the favorable settlement of a major lawsuit, might reduce uncertainty about a company and its future. In other words, any interim developments that materially affect a company and its prospects must be disclosed via amendments to the initial registration statement.

A company can generally expect it to take approximately 30 calendar days from the time the registration statement is filed with the SEC for the Staff to complete its initial review and issue comments. Thereafter, a company can expect to receive several subsequent comment letters from SEC Staff outlining follow-up questions on responses to original comments or additional comments on new or amended information included in the registration statement. Generally these responses range from two weeks (second filing) to a week or less (subsequent filings later in the registration process), so it is critical for SpinCo to include in their plan several rounds of SEC comments and responses prior to effectiveness and file amendments in order to keep the financial information current in accordance with SEC rules.

In addition to filing the registration statement with the SEC, the company must make filings in the states in which the company intends to offer the securities, as well as with the Financial Industry Regulatory Authority (FINRA).

Preparing carve-out financial statements

SpinCo's historical carve-out financial statements will be required to be included in the registration statement. The previous section outlined the specific requirements around the historical periods to be presented for EGCs and non-EGCs and other historical information to be included in the Form 10 or Form S-1. This section highlights the accounting considerations and common judgement areas companies face when preparing carve-out financial statements. This section is intended to provide general guidance regarding the preparation of carve-out financial statements and you should consult your external auditors, where applicable. For further details on specific accounting considerations, please refer to *PwC's Guide to Carve-out Financial Statements.*

Preparing carve-out financial statements can be a challenge. The need for data and numerous judgments can be a struggle, and there is limited authoritative guidance. Care must be taken to determine that all of the assets and liabilities of the SpinCo have been properly identified and that all relevant costs of doing business have been reflected. With the limited authoritative guidance on preparing carve-out financial statements, being aware of current practice will help companies navigate the divestiture process.

As discussed earlier in this chapter, spin-off transactions involve the divestiture of a subsidiary or business unit of a company rather than the whole company itself. In connection with these transactions, a company is required to prepare separate, stand-alone, financial statements of the operations being spun off, commonly referred to as 'carve-out financial statements'. For a variety of reasons, preparing carve-out financial statements can be a significant challenge, and there are many judgements you'll need to make to meet investors' expectations and comply with applicable regulatory requirements.

These financial statements should be prepared on a standalone basis for the historical operations of the SpinCo. These statements could differ from those that would have been prepared had the SpinCo operated on a stand-alone basis. Unfortunately, these statements frequently do not exist and need to be prepared for the specific objective. If financial statements do exist, they may not fully reflect the all costs of doing business, inclusive of items such as corporate overhead costs (reflecting the costs of functions typically provided by the Parent). Judgement is needed in many areas when assessing the basis of presentation of carve-out financial statements, such as impairment and valuation allowance assessments, corporate overhead allocations, attribution of assets and liabilities and the related tax impacts, among other items, to reflect the objectives of the accounting literature and present financial statements of SpinCo.

Creating a consolidated and auditable data set

The preparation of carve-out financial statements can involve multiple business units and legal entities in several countries. This process results in the creation of an "entity" for financial reporting purposes that frequently did not previously exist from a legal or management perspective—referred to throughout this document as the SpinCo. To prepare such financial statements, there may be a need for management to retrieve data from various ERP and financial systems and aggregate the data needed to prepare carve-out financial statements. This is often a difficult and time-consuming exercise. Data may also contain various currencies and be compiled following different bases of accounting—such as US GAAP and International Financial Reporting Standards—as well as differences attributable to the application of business combination accounting. Consolidating and standardizing the data in one central platform ensures that the carve-out financial statements can be accurately modeled with clear and traceable data sources to ease a diligence process and/or audit.

Adapting to changing deal requirements

Depending on the circumstances, the spin perimeter, and how the SpinCo entity is being defined (i.e., the legal entities and/or components that make up the SpinCo entity), may be fluid. In addition, there can be conflicts between the application of GAAP and the terms of the deal that will be addressed in pro forma financial information. The definition of the entity for which the carve-out financial statements are prepared could change before the transaction is finalized. As such, it is best to design a flexible process with the ability to refresh data in a consistent way across the required time periods. As structural changes to the deal perimeter are made during the spin-off process, similar changes should be reflected in the basis of presentation of the related carve-out financial statements on a consistent basis. The audit program and timeline may also be impacted with changes in deal perimeter, so its also important to ensure the audit is designed with maximum optionality to avoid incremental audit work, resampling, and potential time delays.

Basis of presentation

To prepare carve-out financial statements, management must first determine what is being spun off. This determination impacts the operations, assets and liabilities included in the financial statements and the costs to be allocated.

There are generally two approaches used to prepare carve-out financial statements: a legal entity approach and a management approach. Determining which approach to apply depends on the facts and circumstances of the transaction.

Factors that impact how the carve-out financial statements are prepared include:

- The legal structure of the transaction
- The form of the transaction (e.g., spin-off or split-off)
- Whether or not certain net assets and results of operations retained by the Parent can be excluded on a retroactive basis (i.e., a "depooling") from the historical financial statements
- The portion of the legal entity that is being spun off relative to the portion that is not being divested

If the form of the transaction has not been determined, the reporting entity may need to consider each of the possible outcomes, and the reporting requirements of each outcome.

- **Legal entity approach—**The legal entity approach is often appropriate in circumstances when the transaction structure is aligned with the legal entity structure of the divested entity. If it is determined that the legal entity approach is appropriate, all historical results of the legal entity, including those that are not ultimately part of the spin-off, should be presented in the historical financial statements through the date of transfer. If the historical results of operations of the carve-out entity include legal entities that will not ultimately be part of the spin-off, the operations remaining with the parent company should be assessed under ASC 205-20, Discontinued Operations. A legal entity approach is typically used when i) the transaction is a spin-off or IPO and the "depooling" criteria of SAB Topic 5.Z.7, Accounting for the spin-off of a subsidiary, codified as ASC 505-60-S99-1, are not met.
- **Management approach—**In some circumstances, utilizing a legal entity approach may not be appropriate or may not provide the most meaningful presentation of financial information to the users of the carve-out financial statements. This may be the case when net assets that constitute a business, rather than a legal entity, are being spun-off, or when the legal structure of an entity does not align with the business being spun-off. The management approach takes into consideration the assets that are being divested to determine the most appropriate financial statement presentation. A management approach may also be appropriate when a parent entity needs to prepare financial statements for the spin-off of a legal entity, but prior to divestiture, certain significant operations of the legal entity are contributed to the parent in a common control transaction. A management approach is typically used when i) the transaction is a spin-off or IPO and the "depooling" criteria of SAB Topic 5.Z.7 are met, ii) the transaction is a sale that does not represent substantially all of the legal entity or iii) the transaction is the divestiture of net assets (or a combination of net assets and legal entities). **Companies may need preclearance from the SEC if they believe the management approach is an appropriate basis for SpinCo financial statements.**

Depooling a dissimilar business

If the transaction is an IPO or spin-off of a preexisting legal entity, then whether to use the legal entity or the management approach is based on whether or not certain net assets and results of operations retained by the Parent can be excluded on a retroactive basis (i.e., a "depooling") from the historical financial statements. SEC SAB Topic 5.Z.7 provides the criteria for this evaluation. If the criteria are met, then the entity may elect to apply the management approach, presenting only the net assets and operations included in the IPO or spin-off. If the criteria are not met, then the legal entity approach should be applied.

In addition, if depooling criteria are not met, management should assess the operations required for inclusion in the carve-out financial statements based upon legal entity structure only, but not being transferred in the transaction, in the context of the guidance of ASC 205-20, Discontinued Operations.

Refer to *PwC's Guide to Carve-out Financial Statements* for more information on the principles and methodologies associated with the carve-out basis of presentation.

Assets, liabilities, and expenses—common challenges

The assets and liabilities that are attributed to SpinCo will usually reflect the same basis of accounting as that used by the Parent and is presented at the Parent's carrying value. Determining which asset, liability, or expense items should be included in the carve-out financial statements can be challenging. Depending on the circumstances, assets may be attributed to the SpinCo based on legal ownership, usage, or through a contractual intercompany sharing arrangement, such as an operating or lease agreement.

With respect to costs, the historical income statements should reflect all costs of doing business. One of the challenges when preparing carve-out financial statements is the allocation of indirect costs. In SAB Topic 1.B.1, Costs reflected in historical financial statements, codified in ASC 220-10-S99-3, the SEC staff noted the expenses recorded in the historical carve-out financial statements should reflect a reasonable allocation of costs incurred by the Parent entity on behalf of the SpinCo.

The carve-out principles are displayed in the table below, presenting the attribution of assets and liabilities and allocation of revenues and expenses to the SpinCo business:

Nature of transaction	Asset/Liability treatment	Revenue/Expense treatment
Directly related to the historical operations of the SpinCo	Record 100% in SpinCo's carve-out financial statements	
Related to both the Parent (or affiliates of the Parent) and the SpinCo	Record 100% of specific assets and liabilities legally owned by or attributed to the SpinCo in SpinCo's carve-out financial statements	Allocate proportional share to SpinCo's carve-out financial statements to reflect costs of doing business
Not related to the historical operations of the SpinCo	Typically excluded from SpinCo's carve-out financial statements However, in some cases, such transactions and balances are required to be presented in SpinCo's carve-out financial statements when the "legal entity approach" is appropriate and the criteria of SAB Topic 5.Z.7 have not been met	

Other typical areas where companies often encounter challenges when preparing carve-out financial statements include the following:

- Identification, analysis and presentation of SpinCo's segments
- Identification of goodwill and related impairment testing
- Allocation of corporate overhead expenses and shared service costs
- Attribution of corporate debt and allocation of related interest expenses
- Attribution of pension assets/liabilities and related service costs
- Allocation of stock based compensation
- Presentation of intercompany transactions including intercompany loan arrangements and cash pooling arrangements
- Presentation of derivatives
- Identification and presentation of cumulative translation adjustment (CTA)
- Preparation of the carve-out tax provision using the separate return method—SpinCo generally must prepare a tax provision as if it were a separate stand-alone entity under the separate return method for all historical periods presented in the carve-out financial statements. In preparing carve-out financial statements, management should consider tax sharing agreements, net operating losses and tax credits, uncertain tax positions, deferred tax asset valuation allowances, and assertions that cash will be held and used outside of the United States.

Refer to *PwC's Guide to Carve-out Financial Statements* for additional information on typical carve-out accounting issues and methodologies.

For more information on delivering value on your divestiture and carve-out financial statements and the SEC process, please contact:

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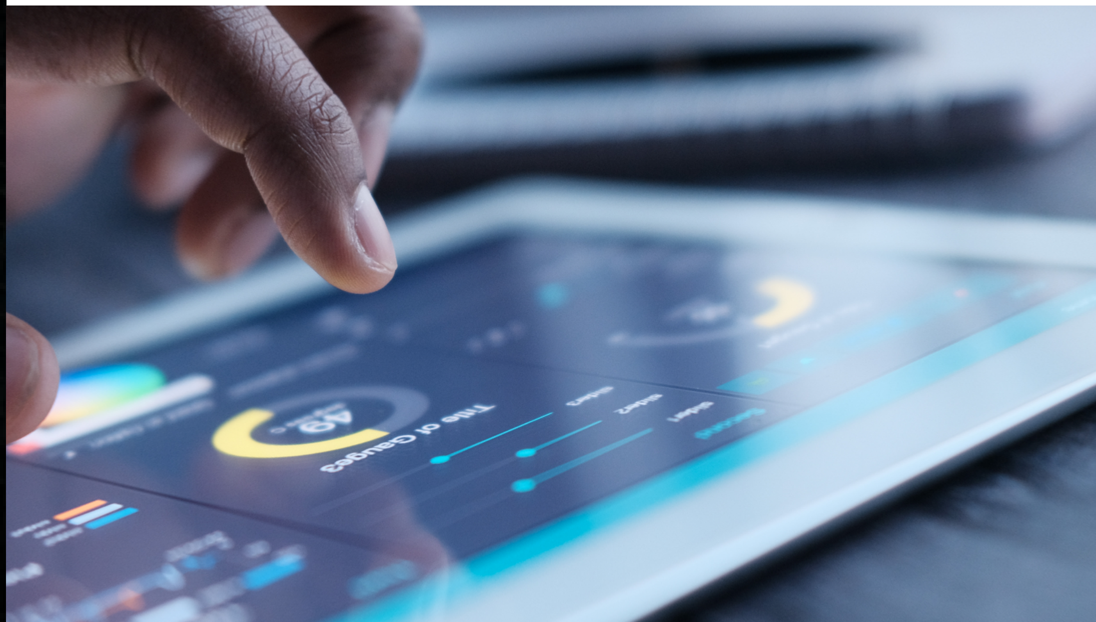
Financial model

In a spin-off, it's important to understand the financial implications of the transaction. Key components influencing the overall value in a spin-off include:

- One-time costs to affect the separation and spin-off
- Stranded costs
- Transition services agreement (TSA) costs
- Dis-synergies and/or business disruption costs
- Ongoing run-rate operating costs of RemainCo and SpinCo

Costs to achieve the spin-off and separation, TSA costs, and dis-synergy costs can be difficult to ascertain early in the divestiture planning process since they require companies to look at their business processes, systems and policies in a more objective manner (i.e., are allocations a true reflection of costs?). Additionally, the availability of accurate information is usually limited, resulting in decisions or actions that may adversely impact transaction value.

Establishing a centralized, yet holistic process which captures the value implications of SpinCo's decision points is critical and comprises what we refer to as the financial model. Gathering inputs to model each value component, determine the level of detail required to inform each value component and draft an evolving model are important. The financial model ensures continued focus on value throughout the spin-off. It enables financial understanding of strategic and operational decision points throughout the spin-off lifecycle. A centralized process helps drive standardization across functions, geographies and business units and ensures "an apples to apples" comparison.



Separation agreements

In a spin-off, a variety of agreements between RemainCo and SpinCo may be required. These agreements can enable a faster transaction close, minimize risk of operational disruption and may be important for continued operations beyond close. These agreements serve as a means to support the SpinCo and/or RemainCo post spin-off by providing services, allowing usage of specific assets, IT infrastructure, facilities, intellectual property (IP), manufacturing products and a variety of other needs.

Examples of separation agreements include:

- Transition services agreements—temporary services between RemainCo and SpinCo to ensure business continuity while RemainCo and SpinCo establish independent operations.
- Commercial agreements—can be temporary or long-term agreements depending on the nature of the arrangement. Commercial agreements typically include the following:
  - IP licensing—where RemainCo or SpinCo allow access to IP for a period of time (temporarily or permanently)
  - Manufacturing services agreements—when the spin-off involves product manufacturing, it is common that RemainCo or SpinCo may produce products for the other post-spin. Both companies will develop terms in the agreements that define the newly established third-party contract manufacturing relationship.
  - Leasing agreements providing access and use of a facility for a period of time
  - Other commercial arrangements resulting from the separation of bundled services or product offerings

Many of the key points to be included in separation agreements require negotiation and alignment from both RemainCo and SpinCo, especially around scope, value and performance requirements. You should make sure the following key points are addressed in the separation agreements:

- The fee for the general scope of services and access to assets
- The fee for additional charges for services and access assets not contemplated in the defined scope
- Specific performance or service level requirements
- The term of the requirements and any available renewal terms
- The dispute resolution mechanism to deal with discrepancies between RemainCo and SpinCo
- How the agreement will be transitioned or terminated

Identifying the need for separation agreements often begins early in the spin-off planning process. As the perimeter for SpinCo is defined, an inventory of IP, people, assets and systems should be conducted to determine which are specific to SpinCo, RemainCo or shared. A mix of functional and business domain expertise is required across the organization including legal, tax, finance and then the functional area (product development, IT, facilities, operations, etc.) to identify, develop the approach and provide input into the agreements. The agreements are usually updated, being informed by the operational separation and finalized as part of the spin-off.

Dual track process

When pursuing a divestiture, a strategy with built-in optionality is often the key to unlocking maximum value. Though a single-track approach can be taken where you might only prepare for a spin-off scenario, a dual track approach can be followed where a sale is also a scenario that is planned for simultaneously with the spin-off. In considering a dual-track approach, there are specific considerations to keep in mind to ensure you don't overburden already stretched resources and complete the transaction that is right for your organization.

Sometimes it's not clear if your best option is to sell or spin-off. In that case, exploring both is a good idea but it needs a thorough analysis. Selling a business often commands a premium price and the seller can share in some of the synergies the buyer might capture. However, a sale may still have significant tax consequences. The analysis of the purchase price range and the tax consequences are relevant. Researching a list of potential buyers and qualitatively and quantitatively assessing the likelihood of receiving higher price from certain buyers will help discern the value trade-off between a spin-off and a sale.

To successfully divest part of a larger organization – whether that part already operates as a mostly stand-alone unit or is tied to a broader segment—the Parent should first conduct its sell-side due diligence on the business. This will help identify issues which may impact value during the sale process and provide a realistic view of the business.

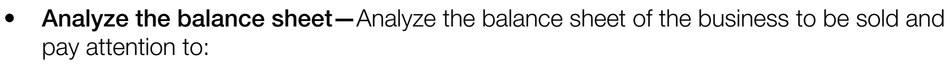
Sell-side due diligence takes a close look at the specific details of the business including the quality of earnings and operational details. This identifies risks and opportunities and develops the right messages and supporting documentation to preserve and maximize the value of the deal. Doing this diligence before buyers get started on their own diligence activities allows the Parent to compile consistent and accurate financial information ahead of the buyer's diligence activities.

In the due diligence process, you should assess and analyze the divestiture from a buyer's point of view and identify all possible issues, risks and opportunities that may impact deal value. We've listed below the key activities in the due diligence process:

- **Prepare data driven insights—**Run a performance diagnostic on the underlying business based on historical financial information and contrast it with industry benchmarks. The diagnostic will provide insights on trends across products/services, customers and geographies on key metrics, some of which include:
  - Historical price/volume elasticity
  - Revenue growth
  - Marketing effectiveness
  - Operating margins
  - Net working capital

Also, performing an analysis of disaggregation of value by products and/or service and/or geographies to understand the highest at value risks and opportunities will help you set the transaction perimeter. Identifying key performance drivers, which will increase the value of the underlying business, will also highlight the opportunities that the potential buyer will have to increase value in the future.

- **Proforma historical analysis—**Look at business trends and key performance indicators such as:
  - Revenue and profitability by segment, region, and key customers
  - Business metrics (like price and volume by plant, product line, and revenue type)
  - Components of cost of sales and key suppliers
  - Expenses for selling, general items and administrative items (and related headcount)
  - Manufacturing capacity and how it's been used
  - Any foreign currency impact (look at any underlying operational foreign currency risk—transactional and translational—and do constant currency analysis)
- **Analyze the quality of earnings—**Build a quality of earnings analysis to understand the normalized run-rate EBITDA of the business reflecting possible adjustments.
- **Build a forecast analysis—**Refine assumptions used in the forecast analysis and how it compares to historical metrics and to the competitive landscape. Help stakeholders understand value consumption and creation patterns within the company at a granular level (products, customers, segments, geographies, etc.) in order to drive better resource allocation and optimize parts of the business where value is being consumed and double down on areas where value can be maximized. The overall objective is to drive maximum value creation through efficient resource and capital allocation.



- **Analyze the balance sheet—**Analyze the balance sheet of the business to be sold and pay attention to:
  - Trends in key accounts (like accounts receivable, inventory, AP, accrued expenses and working capital)
  - Reserve movements (like reserves for bad debt or inventory)
  - Quality of net assets (to identify any adjustments or non-recurring balances which may be adjusted when determining a net working capital (NWC) peg for a purchase agreement)
- **Align on a purchase price mechanism using net working capital (NWC)—**The seller and buyer should agree on a purchase price mechanism using net working capital. This helps protect both the buyer and seller between the date they sign the purchase agreement and the date they close the transaction. You should quantify and understand trends in historical NWC, which can help estimate and set a normal level of net working capital at close. And it helps with the terms and definitions of the mechanism in the sale and purchase agreement.
- **Identify debt and debt-like items—**Identify any issues around debt or debt-like liabilities that could lower the purchase price. Then figure out what your messages about them will be during the sale process.
- **Analyze revenue and margins** (for the business being sold)
  - Look at revenue by customer, product and region.
  - Understand customer profiles. Look for potential impacts which may impact valuation.
  - Understand the impact of related party transactions between SpinCo and Parent in order to assess impact on business post divestiture.
- **Adjust costs for a stand-alone or integrated business**
  - Understand procurement and supplier relationships to assess impact post spin-off. For example, supplier costs might increase post transaction because it buys products at lower volumes via the Parent.
  - Adjust any estimated costs based on how the company will operate as a stand-alone business. Consideration should be given to ensure stand-alone costs are accounted for whether naturally occurring by the business historically or layering in a cost not previously charted to the business by the Parent. For example, reported results might not reflect costs for some back-office functions performed by the Parent (like legal, HR, IT and finance). You should estimate these based on what it will take to run the carve-out as a stand-alone business.
  - Be sure to understand who the potential buyers are and how they plan to use the business. If they plan to integrate it with a larger organization, the seller might not need to include some back-office functions and stand-alone costs as part of the sale.

Here are some additional tips to help you make the most out of the due diligence process:

- Look for potential issues or opportunities with the valuation and put together the right messages about both positive and negative findings.
- Find anything that might adjust the valuation, either upwards or downwards.
- Prepare to discuss anything which might be perceived negatively as well as upside considerations.
- Look for other issues which may arise as the deal closes around separating HR and IT, tax structuring, post-divestiture service agreements (and related headcount) and business location. Know the ins and outs of the divested business and share those details when creating the data room for the potential buyers.

For more information about delivering value through divestitures and sell-side diligence, please contact:

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Operational separation and optimization

It's clear that a spin-off can create value for investors. It's less obvious that you can unlock extra value by optimizing operational separation activities. With appropriate attention to planning for operational separation, your teams can allocate time to high-value areas to ensure your spin-off is a success.

In this section we cover:

Establishing a separation management office

Separating a piece of your business can be daunting once you begin to think through the far-reaching implications for each functional area within your corporate structure. The good news is that there are proven ways to make the process easier, starting with a team dedicated to managing the separation in a way that helps both SpinCo and its Parent and a clear roadmap to guide you along the way.

Designing the target operating model

Establishing the target operating model for the RemainCo and SpinCo will organize people, processes, technology and data to make the desired state a reality.

Organization design and talent selection

Determining the future organizational structure and talent selection is key to ensure business operations continue to run smoothly and competitive edge in the market is maintained.

Developing transition services agreements (TSAs)

Carefully scripted TSAs will ensure SpinCo is supported in the right ways for the right amount of time right out of the gate.

Contracts separation

Separating contracts is often a long-lead time area. Planning ahead can help you bring the right parties to the table to ensure a successful transition while minimizing potential revenue and cost impacts.

Legal entity separation considerations

Ensure a coordinated approach to legal entity separation to preserve deal value.

Stranded and separation costs

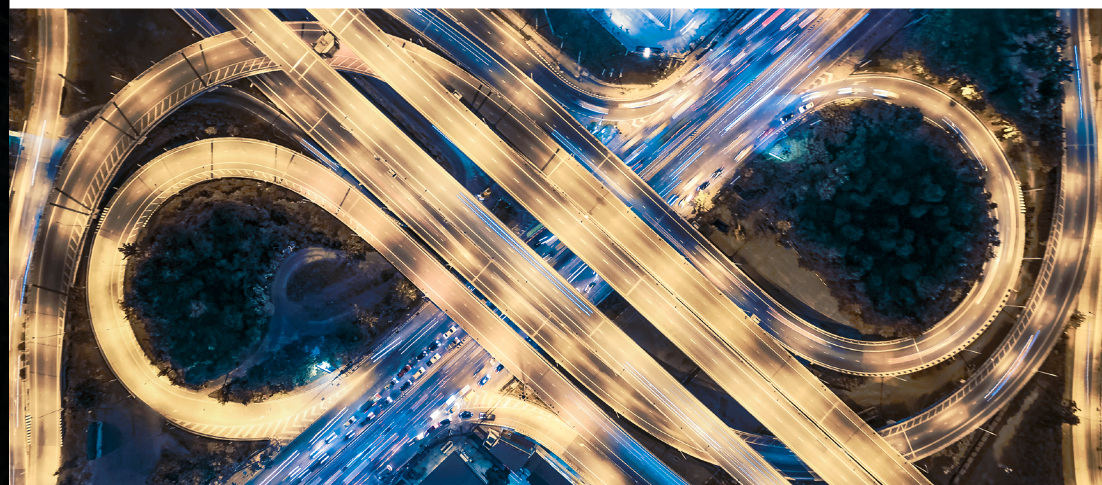
Identification and management of stranded and separation costs can help you unlock deal value. We'll explain how.

Change, communications and culture

Establishing an effective change and communications program minimizes distractions that may result from uncertainty and fear and provides stakeholders (internal and external) with the right level of transition support.

Optimizing while you separate and post-spin-off

Successful spin-offs happen quickly and systematically. But you need to plan for every contingency and think proactively about optimizing operations post spin-off.



Establishing a separation management office (SMO)

It's important to maximize the spin-off value and optimize the value of RemainCo over the long term. To succeed, you need a governance structure that puts people, process and systems in step with the separation objectives. That's the SMO's role.

An SMO is the central touchpoint for every function involved in the spin-off, and it must be designed to meet RemainCo's and SpinCo's needs. A SMO, staffed by experienced people, defines a common timeline and methodology. That makes sure the separation stays on course and the people involved focus on the right activities at the right times. A SMO does this by:

- Defining the fundamentals of the separation, including the degree of separation and the essential and non-negotiable requirements for every function and stakeholder groups
- Mobilizing the separation teams by appointing qualified team leads for each of the business functions
- Establishing clear roles, responsibilities and decision rights
- Establishing a disciplined approach to coordinating the separation activities across the organization
- Sequencing the roll-out of the separation methodology and tools, including status reporting, managing dependencies and issues and establishing the pace and cadence for the separation
- Identifying issues, decisions and resource constraints and escalating them for management to resolve
- Launching key communications and the communication-planning process

The SMO serves as the nerve center for coordinating all separation related activities. The SMO drives consistency across functions and cross-functional workstreams.

Designing the target operating model

The target operating model (TOM) defines the desired state of the RemainCo and SpinCo in each phase of the transition throughout the deal cycle. Common separation phases include pre spin-off planning and readiness, spin-off execution, post-spin-off transition, and ultimately, full separation.

Both RemainCo and SpinCo should focus on core operational elements to understand how much change is involved in each phase of the transition. To achieve the target operating model, here are some of the core elements and the questions to ask for each element.

- **Organization:** How do RemainCo and SpinCo's organization evolve for post spin-off structure, vision and business imperatives?
- **People:** How are employees of RemainCo and SpinCo affected? How will you transition employees to support RemainCo and SpinCo?
- **Processes and controls:** How are RemainCo and SpinCo's processes and controls impacted? How do they need to change to support both companies' operations?
- **Technology, data, and security:** What systems and data sets are impacted across RemainCo and SpinCo? How is data and intellectual property secured from internal and external threats? How do they need to change to support both RemainCo's and SpinCo's operations? What data do you need to support each?
- **Assets, liabilities and facilities:** How and when will assets, liabilities and facilities separate?

Both RemainCo and SpinCo need to understand the changes in each phase of the separation process. A TOM helps you structure the plan and assess how each phase affects operations. It also gives you a roadmap for the activities you need to complete.

Developing the long-term transition operating model

After Day One, you need to develop a long-term operating model. That will help inform your choices about operations after SpinCo separates from the Parent. A long-term operating model focuses on where and how critical work will be needed to make sure SpinCo's long-term business operations are profitable and produce growth. A successful TOM simplifies SpinCo's operations and reduces duplication of activity while also giving customers flexible and responsive service.

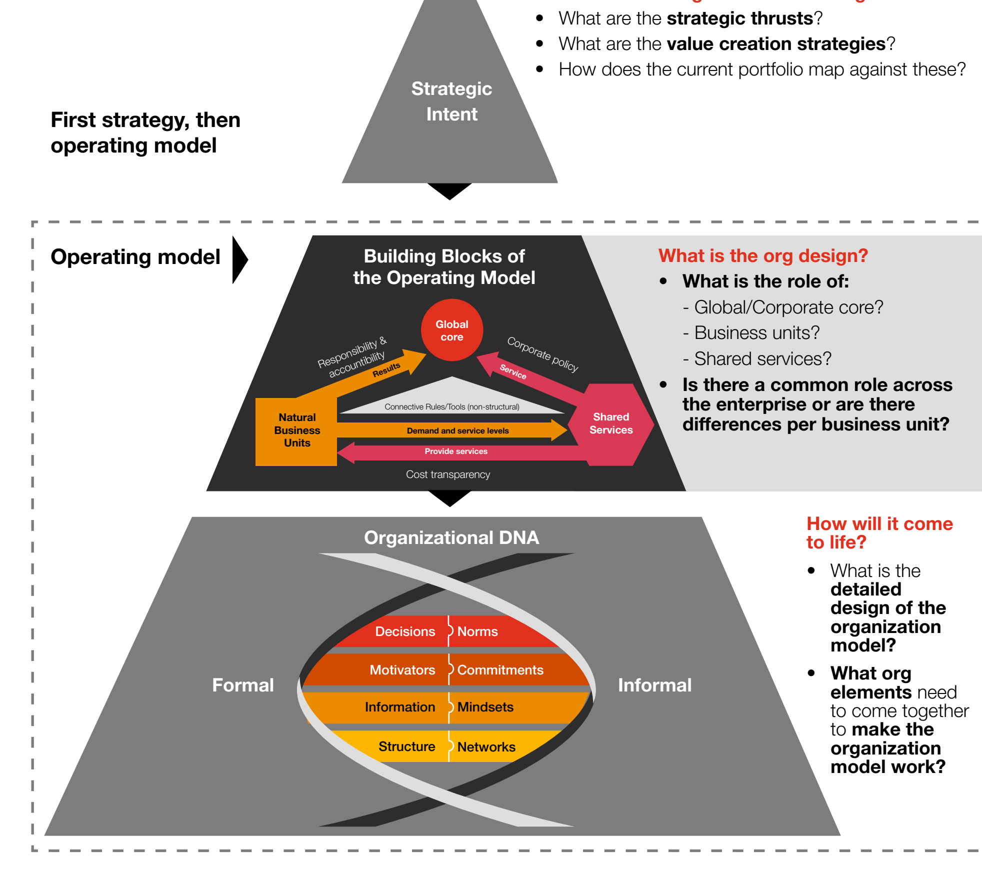
The long-term operating model should build on the Day One operating model to organize and execute SpinCo's final state strategy.

Organization design and talent selection

The key to a successful separation is making organizational design choices rooted in how to deliver SpinCo's strategy effectively. Business/functional leaders will need to reassess their teams in light of the separation with a focus on a revised future scope of work and span of control. Early understanding of the desired operating model is required to assess capabilities, gaps and associated costs required to adequately support SpinCo. Following a structured process from early stages of launching the team to the creation of a new operating model will help ensure all activities are appropriately considered:

- **Launch team:** Launch team as part of an overall integrated SMO program. Identify key leaders and data sources required for the current state assessment.
- **Baseline current state:** Baseline key attributes (e.g., headcount, labor cost, global footprint) for both employees and contractors. Map key fields to relevant business units.
- **Synthesize strategy:** Interview leaders to highlight differentiating capabilities required and translate findings to impact on current state organization.
- **Analyze organization:** Review core functions/business and collect comparable industry benchmarks.
- **Organization efficiency assessment:** Conduct functional efficiency benchmarking and span of control assessment. Compare performance across businesses.
- **Develop, validate and recommend new operating model:** Develop initial operating model options for SpinCo. Hold workshops with leadership to review options and translate workshop decisions into recommended operating model.

Before diving into future operating model design, it is important to first consider SpinCo's overall strategy. The strategic intent of SpinCo provides guiding principles on which building blocks of a new operating model are formed. The role of the operating model is to enable efficient execution of each function's activities in line with the overall strategy of the new organization and not the other way around.



Organization design

With the new operating model established, organizational design goes beyond just aligning required positions/job level to organization jobs/roles. A well-designed organization provides insight into customer-facing business and operations, enabling functions support, locations, key performance measures, key roles and role types. Organization design must take structure, roles, capabilities and resources into account while prioritizing employee readiness.

- **Design organization top layer:** Translate operating model decisions into CEO + 2 level organization design. Then define roles, responsibilities and decision rights for these top layers.
- **Design granular organization:** Identify required information flows to develop organization charts depicting information flow through lines and boxes.
- **Size resources:** Leverage benchmarks to size organization. Then quantify the number of resources required and define the target span of control.
- **Develop role profiles:** Identify role families required in each of the functional areas. Each role will require profiles addressing responsibilities with metrics.
- **Review and validate:** Validate synergy targets with leadership and develop roadmap.

Talent mapping, selection and retention

The scope and complexity of organizational design is further complicated by a direct dependency on talent selection. A consistent and objective approach is required to empower leaders to thoughtfully select the best fit talent for positions in SpinCo's organization.

- **Define assessment and selection approach:** Establish talent framework and process with defined selection criteria and guidelines. Identify dedicated and shared headcount by function and geography.
- **Gather and review performance data:** Gather employee performance information and determine how shared talent allocate their time. Develop assessment tools and materials to measure key performance metrics important to SpinCo.
- **Perform assessment process:** Assess talent against selection criteria and future business needs. Identify pivotal talent and areas of knowledge drain risk.
- **Select talent:** Select talent using consistent criteria and identify critical talent.
- **Develop transition plan:** Identify and prioritize critical positions. Put in place retention plans for critical employees at risk.

The selection of talent must align to an overall talent strategy linked to SpinCo's core business objectives. We've illustrated below key considerations for the value drivers, key dependencies and risks and perspectives related to talent strategy.

Value drivers	Key dependencies/risks	Perspectives
• Comprehensive understanding of talent risks and opportunities • Retention of the best of talent during all activities to maximize transaction value • Identification of top talent to fill future leadership needs • Streamlined process for onboarding and offboarding employees • Succession planning and leadership development strategies • Aligned performance management strategy and processes • Existing/institutional and market knowledge	• Size and breadth of the workforce adds complexity, and may require customized strategies for certain businesses/regions/functions • Senior leader misalignment, causing slow, sub-optimized decision-making and re-work • Selecting key leadership positions, retaining talent and managing current and future resource requirements • Gap in critical roles requiring external talent • Talent loss, particularly during transition • State of labor relations across businesses/locations • Degree of shared corporate talent across business units	• Push difficult leadership conversations early, driving a single vision at the top • Select leaders based on priority competencies and ensuring fit with future needs • Involve those employees viewed as critical and key during the design process as a mechanism for retention • Establish retention programs for key high performing leaders and staff during and through the transition to protect transaction value • Build cross-company framework to create familiarity and knowledge transfer early on • Incorporate succession planning into talent selection process • Aggressively market the brand to attract tomorrow's top talent

It is common for separations to have inherent retention issues resulting from uncertainty of job security and future organizational direction, loss of morale or changes in culture. To help manage expectations and retain critical talent, identify top performers and pivotal roles early. Be transparent in the assessment process and communicate future possibilities.

- Identify the top performers and determine if there is a potential flight risk. Create messaging customized for these top performers.
- Be transparent about the employee assessment process and communicate clearly how promotions, transfers and job changes will be handled in the transition period to avoid employees building their own narrative.
- Announce the organization early to diffuse concerns about the new organization and employee's role in the future organization.
- Rapid hiring of critical SpinCo hires is imperative and requires close collaboration between RemainCo and SpinCo for identification, hiring and onboarding of employees.

After the spin-off, be prepared as the organization structure continues to evolve beyond the Day One organization. As SpinCo evolves, a new operating model will evolve which will in turn require a longer-term organization structure and staffing planning. Maintain transparency in the planning process and keep in mind the need to retain and attract the right talent for the new organization.

Developing transition services agreements (TSAs)

A transition services agreement (TSA) is a legal document to provide specific services between SpinCo and RemainCo to maintain business continuity until each company can operate independently. These services can pertain to shared services, assets, facilities, etc.

A TSA can accelerate the spin-off timeline by allowing the separation to move forward without waiting for SpinCo to assume responsibility for all critical support services.

Why are TSAs necessary?

In most spin-offs, full separation cannot be achieved by the spin-off date (Day One). Companies use TSAs as a means of support to ensure business continuity after Day One. TSAs are important tools to help RemainCo and SpinCo arrive at an approach for achieving a clean separation. TSAs offer several advantages to both RemainCo and SpinCo:

1. **Faster close:** A TSA can accelerate the spin-off by allowing the separation to move forward without waiting for SpinCo to assume responsibility for all critical support services.
2. **Smoother transition:** TSAs ensure business continuity for both SpinCo and RemainCo while separation and stand-up activities are underway post spin-off.
3. **Reduced transition costs and end-state solutions:** Since RemainCo supports critical services for an agreed upon duration, SpinCo is able to build "fit for purpose" business processes, systems and infrastructure.
4. **Reduced risk:** TSAs are a legally binding obligation for Parent to complete the separation post-close, thereby minimizing legal and commercial exposure to both RemainCo and SpinCo.

Challenges with TSA development

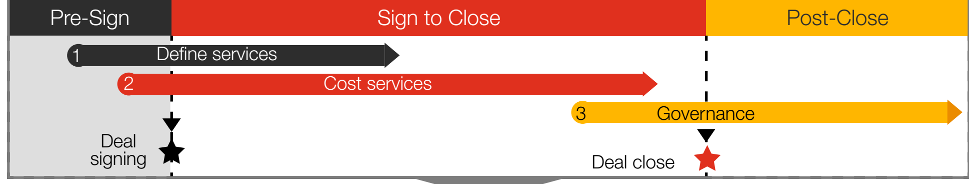
In most cases, the objectives of RemainCo and SpinCo may be in conflict in the context of TSA scoping and development. This also involves a significant amount of time, cost and effort. As such, it is critical to understand common challenges in TSA development and how to mitigate them.

- **Day One continuity:** Delaying identification of TSA scope and development of TSA schedules might pose a risk to business continuity of SpinCo post Day One. Thus, TSA scope needs to be identified immediately after the blueprinting exercise for IT is complete, enabling sufficient time for SpinCo to stand up IT capabilities needed post Day One.
- **Regulation:** For spin-offs across multiple countries, it is essential to ensure that regulatory requirements of each in-scope country is factored into TSA development. IT must work with business and legal teams as part of TSA scoping efforts.
- **Legal:** Customer, vendor and lease agreements may require consent or prohibit the Parent from providing services/licenses to SpinCo without renegotiation. Key restrictions need to be understood early in the process to avoid legal penalties and to inform the separation strategy.

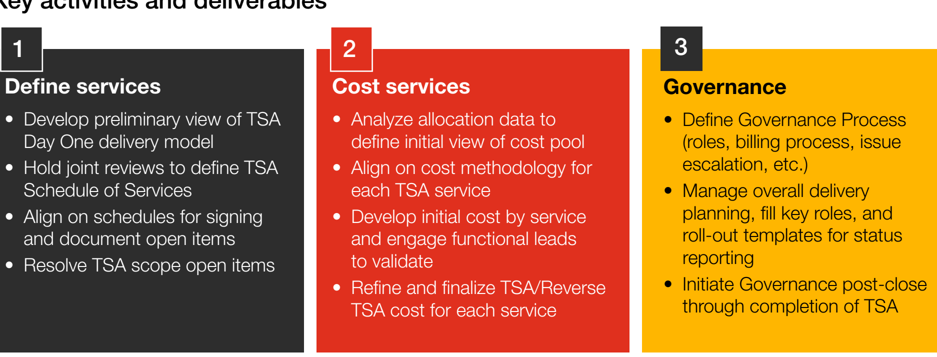
- **Internal stakeholders:** Given the breadth of IT services and cross-functional implications, the right set of IT and business stakeholders need to be involved in the TSA documentation exercise to ensure full scope of services is covered, where applicable.
- **External stakeholders:** IT contracts with third-party vendors are a critical part of ensuring business continuity post Day One. Since these vendors are not obliged to perform transition services, any services needed from them must be a contractual obligation. Thus both RemainCo and SpinCo need to ensure contractual rights to transitional services.

Approach to TSA development

TSAs are developed in three phases: define services, cost services and governance. We discuss the activities under these phases in detail below:



Key activities and deliverables

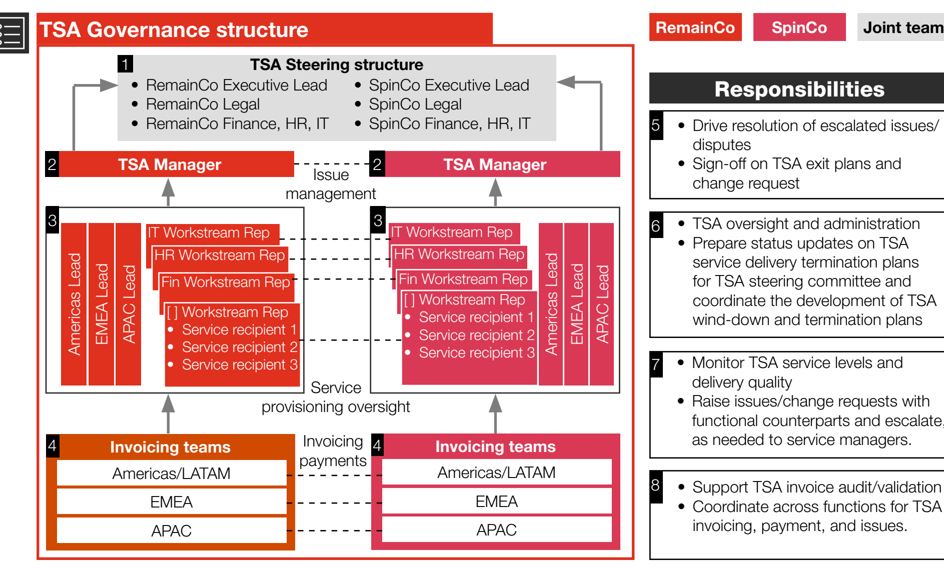


TSA governance stand up

With sufficient time before the spin-off, you should establish a TSA governance model with service coordinators and leaders. The main purpose is to establish a framework to help execute TSAs in line with the target operating model. TSA governance processes should include:

- Coordination between functions to facilitate dispute resolution
- Issue escalation path and matrix
- A process to monitor performance and refine TSAs as appropriate during transition period
- Time-tracking process and tool to charge TSA fees
- A process to develop a TSA exit plan

The components of the TSA governance structure and governance responsibilities are illustrated below:



TSA execution and ongoing governance

You should make TSA execution part of a cross-functional SMO workstream. That will help to make sure you manage the TSA governance structure efficiently and deliver services as expected. The master TSA services agreement should reflect that services change over time, along with the separation of SpinCo. As that happens, cost and invoicing will also change and should be considered as part of the cost-tracking mechanism.

Depending on the duration and volume of TSAs, a separate TSA management structure may need to be established on both RemainCo and SpinCo, coordinating daily management as well as separation efforts across functions.

Weekly check-in meetings

Function leads and service coordinators escalate disputes to TSA managers

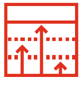
TSA managers meet on a weekly basis during the first six months to discuss issues

Negotiations

TSA managers negotiate in good faith to resolve dispute

Resolution to occur within 20 days

If no resolution, dispute is escalated to steering committee



Escalation

Steering committee attempts to resolve dispute

Examples of escalations can include: Service scope being performed doesn't match agreement, service quality lower than agreed to, service provider non-responsive, etc.

Other remedies

If steering committee fails to come to a resolution, either party may seek other legal remedies as outlined in the TSA

No parties are to withhold service while the dispute is being resolved, until the service is validly terminated

TSA considerations for impact on control environment

Typically, TSAs are thought of as providing "business as usual" activities, but it is commonly overlooked that within these services, there is an element of separation in determining what is RemainCo's vs. SpinCo's in order to provide the services, relative to SpinCo's information. When operationalizing TSAs, there are new processes developed and changes to key financial business processes that can often have an impact on existing controls/Sarbanes–Oxley Act (SOX) environments, as well as create new financial risks from the net new activities developed.

The following are some key considerations in the planning and development of TSAs:

- **Existing control environments:**
  - Control owners and executors: Ensure there will be control executors that are appropriate (based on job responsibility) and independent.
  - Security and access: Work with legal to determine sensitive data per US Federal Trade Commission (FTC) antitrust guidelines, and ensure restrictions are in place for both companies. Design enterprise resource planning (ERP) security so that access is restricted appropriately for each company in order to maintain SOX compliance.
  - Materiality and thresholds: Define materiality and assess appropriateness of thresholds for SpinCo, as existing thresholds defined in Parent systems and impacting downstream approval workflow (e.g., manual journal entries, invoice, purchase orders) may require updates.
- **New business processes to support TSAs:**
  - Understand common areas with new processes that may require distinct transaction processing.
  - Develop a process to accurately separate cash collected between SpinCo and RemainCo.
- **Controls/audit within the TSA:**
  - Understand TSA requirements to provide SpinCo with stand-alone controls and associated monitoring or auditing.
  - Validate completeness and accuracy of key reports and data that is provided to SpinCo through the TSA.

TSA costs

The process for deriving TSA costs can be complex and is often part of negotiations between those involved in the separation. Several factors make this process more complex. They include assessing everything involved in delivering the TSAs (like infrastructure, third-party agreements and personnel), and working out SpinCo's capabilities, to "right size" the TSAs. There are also the one-time costs of establishing the TSAs and the recurring costs of delivering and winding down TSAs at the end of the transition.

Contracts separation

Commercial and supplier contract separation is an integral part of any spin-off transaction as it has a direct impact on the revenue and cost portability, respectively, of the business. Analysis of potential impacts to assignment, change of control and overall contract novation that can positively impact pre- and post-announcement workstreams specific to quality of earnings, contract compliance and cost mitigation is critical. In order to reduce execution risk in the pre spin-off and post spin-off transition phases it is important to analyze contracts with regards to their embedded and enforceable terms and conditions. The key benefits of performing contract separation analysis early in the separation include the following:

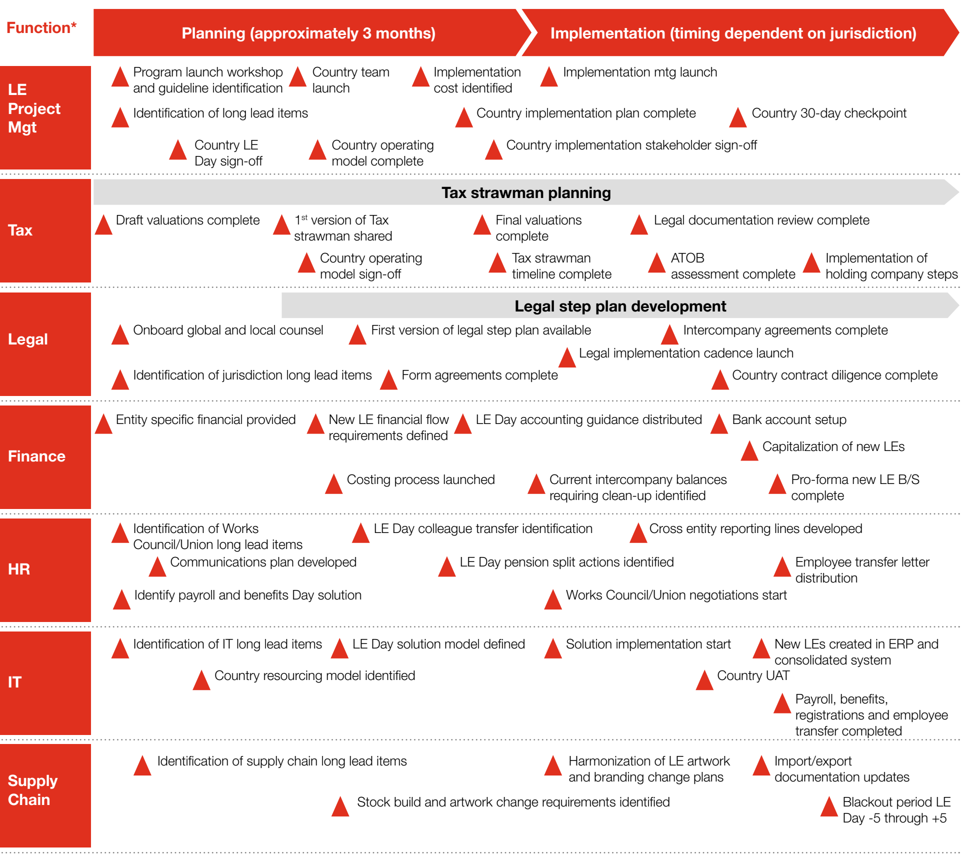
- **Augmenting the data room—**Creation of a streamlined process to disclose material contracts as required for filings or diligence processes without having to resort to an arduous disclosure process.
- **Realizing the pre-deal cost to achieve—**Quantification of cost impacts arising from contractual commitments and liabilities that may affect budgets (both on commercial/revenue and cost/supplier contracts).
- **Designing more effective TSAs—**Design TSAs effectively by consolidating contractual obligations, operational needs and cost implications arising from contract limitations. This may also allow you to execute TSAs through vendor consent which may lead to minimized costs from non-compliance and/or vendor audits.
- **Identify and tackle commingled contracts—**Early insight into commingled customer and supplier contracts helps with more effective execution of contract separation. Key customer relationships can be identified and risks mitigated. Costs can be managed by identifying supplier costs to splitting contracts and ensuring compliance with usage and deployment.

Highlighted below is a typical contract separation process:

	Phase I— Contract setup	Phase II— Negotiation & execution	Phase III— Assignment & allocation
Contract review Identification of critical operational customer/vendors and legal/regulatory obligations across vendor contracts	• Create detailed categorization to identify critical customers/vendors based on – Revenue/spend – Operational/day one Criticality – Contract complexity • Perform a detailed customer/vendor contract review leveraging the automated contract review and disposition platform to ascertain contractual impacts such as Assignment/CoC consents,TSA restrictions, Re-negotiation clauses etc.	• Establish Transitional Services Agreement (TSA) and Assignment qualifications • Align TSA provisions to IT strategic plan • Create detailed timelines and trackers to ensure that priority contract separation and compliance is being achieved through the TSA/Assignment	• Execute Formal assignment of all shared and SpinCo contracts including AP and accounting handover • Execute formal contract separation and re-contracting for all RemainCo and SpinCo contracts without assignment or TSA rights • Document & transfer all contractual and vendor liabilities from RemainCo to SpinCo
Customer/vendor engagement Engagement of Customers/Vendors to communicate separation and ensure compliance to contractual obligations	• Prepare legal communication (e.g., Notice/consent to assign, Consent to TSA) • Design a detailed customer/vendor engagement and disposition plan to ensure that contractual separation is in line with listed requirements and customer/vendor obligations	• Execute customer/vendor communication plan to ensure legal letter distribution • Conduct customer/vendor follow-ups to ensure signed consents have been obtained • Enter into preliminary customer/vendor negotiations with priority customer/vendors to effectuate the separation process	• Create detailed document/contract separation from a contract management/system perspective • Conduct knowledge transfer and handover of customer/vendor plans, contracts and communication
Transition budgeting Track transition budget to ensure spend management and allocation of costs from RemainCo to SpinCo	• Design pro-forma vendor disposition and one time transition costs • Draft budgeting plans – Transition costs – Compliance costs – Implementation costs	• Track additional contract spends to allocated budget	• Track budgeting plans against actuals – Transition costs – Compliance costs – Implementation costs

Legal entity separation considerations

An integral part of unlocking and protecting value as part of any spin-off is ensuring a coordinated approach to legal entity separation. Most companies have commingled legal entities that require moving operations into new ownership structures to facilitate spin-off transactions. Internal transfers of operations require careful coordination between tax, legal, finance, HR and supply chain/operations to achieve tax efficient transactions, speed to spin-off execution and limit one-time operational cost and burden. As with many other components of a successful spin-off, transfers must occur seamlessly and without disruption to SpinCo's business.



* Represents functions most impacted by LE stand-up; engagement of other functions required

Legal entity separation plan

Companies should structure a legal entity separation team consisting of tax, legal and operational experts who will work together through the phases of design, planning and implementation. Having teams work in parallel will allow informed decision-making on trade-offs prior to reaching critical transaction milestones. For example, if the tax team recommends an asset transfer of a manufacturing plant that will result in product stock-outs, knowing of the operational impact prior to starting legal filings allows workarounds to be identified before locking in a plan. As teams move into implementation, a comprehensive plan of tax, legal and operational steps is required, typically following these major buckets of activity:

- **Development of legal entity transaction structure:** First draft of tax efficient transaction structure and steps to achieve spin ownership structure
- **Entity due diligence:** Composition of assets, liabilities, people, contracts and licenses in entities that will require business transfers
- **Country design and prioritization:** Balancing unique country factors and overall corporate resources to develop individual country operating models and a global execution timeline
- **Development and review of step plans:** Simultaneous development of tax, legal and operational steps to achieve timeline country operating models and timeline
- **Implementation and readiness review:** Careful tracking of milestones, filings and documentation allowing transaction timelines to be achieved

Development of legal entity transaction structure

Tax cost is probably the largest potential source of value destruction in a spin-off. In addition to taxes related to the creation of a new public company, companies have to be aware of taxes related to packaging up the business at a jurisdictional level, transfer pricing and ongoing indirect tax cost between entities. Given the many different impacts tax could have on the separation approach and specific steps to qualify as a business transfer, the first step in legal entity structuring for a spin typically starts with a draft proposal from tax.

The draft tax macro-step plan allows legal and operations to start identifying impacts and counter-proposals for consideration.

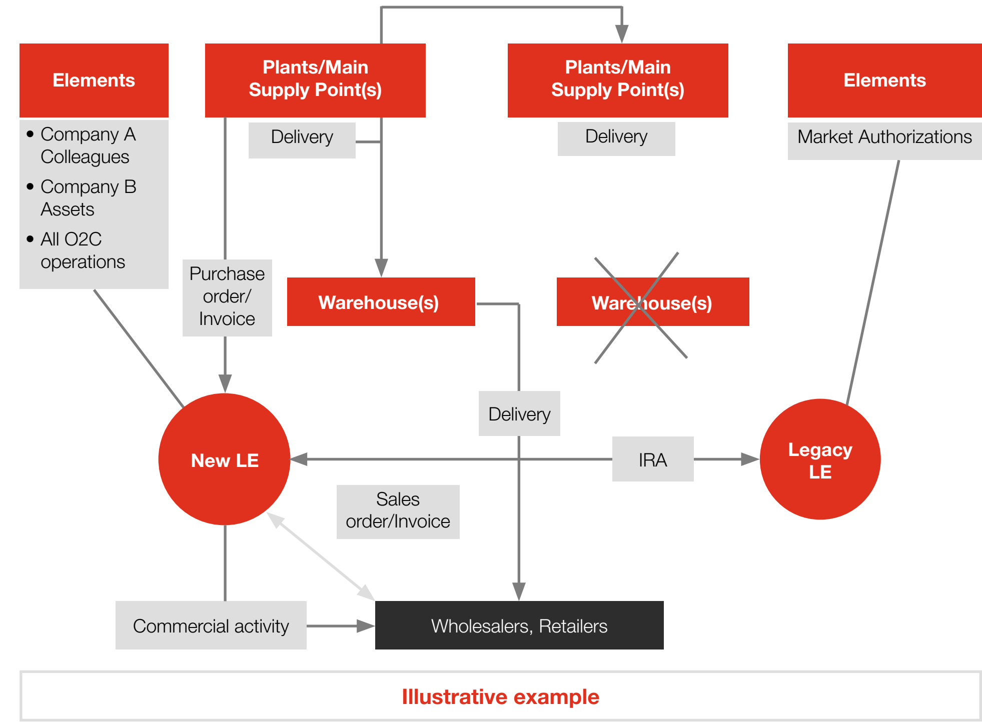
Entity due diligence

With a proposed tax step plan available, legal and operational teams can begin assessing scope and impact to SpinCo. Entity due diligence is not only about collecting financial information on entities but understanding how the businesses operate. Operational assessments should include business licenses, customer connections (e.g., invoices) and employees to understand where unique circumstances require workarounds. Developing a strong, cross-functional baseline of information on entities allows the legal entity separation team to build alternative approaches or exceptions to designing a legal entity as a clone of the existing entity before issues arise and impact cost or timelines.

Country design and execution

With baseline information gathered to understand scope of legal entity separation, the company can move into design and planning. Legal entity separation teams are responsible for aligning on the country operating model, or how the new legal entity will conduct operations in relation to customers, vendors and other entities in the structure. A standard set of design guidance is put in place to accelerate the decision-making process while ensuring minimum tax thresholds and legal constraints are taken into consideration.

However, constraints may arise that require unique workarounds in the country operating model and a different set of decisions that can only be solved through discussions with cross-functional teams. As a starting point, each function should develop guidance on what should transfer and how a new operating entity will interact with counterparties moving forward. The legal entity separation team should lead all functions in developing a one-page design showing physical and financial flows, which entity holds business licenses, where employees sit and where business assets and liabilities are held. Design guidance should consider all SMO and TSA decisions to avoid opposing points of view on Day One operations.



When constraints prohibit the use of global design guidance, alternative approaches should be identified and deployed in select countries to achieve the desired tax treatment. Other operating models should be reviewed as a collective to understand if another model can be deployed such as disclosed/undisclosed agencies (e.g., existing legal entity (LE) invoices and collects cash for new LE) or net economic benefit (e.g., new LE receives a dividend for economics of the business while it is controlled by existing LE). Establishing alternative approaches may reduce the amount of work or accelerate a country close to align with the overall transaction.

Once country models are determined, the team can build a global execution calendar. The speed of legal entity separation for any given country is determined by regulatory requirements, both on transaction type (asset vs. demerger vs. share transfer) and obtaining required business licenses. Typically, the best way to build the global execution calendar is to stage country go-live dates over a number of months, balancing the size of the business to limit disruption to current operations.

Development and review of step plans

Once country design and timeline have been established, comprehensive plans can be developed balancing risk and workload. Plans need to be at a granular level to understand who is responsible and what protocols are in place for the sequencing of legal filings. In many cases, operational work is required to support tax and legal filings (e.g., valuations, audits, works council approval). These interdependencies should be called out.

Implementation and readiness review

Unlike an acquisition where certain steps can be delayed while achieving overall deal value, delaying steps in a spin transaction can delay value realization. In order to ensure step sequence is maintained and countries are progressing towards deal timelines, a robust tracking process focusing on critical milestones is required.

Milestones need to cut across tax, legal and operational steps to provide a proper view to decision-makers and those accountable for issue resolution. Much of the risk in achieving legal entity separation is driven by third-party dependencies or timing of government completion of government processes. Tracking milestones and third-party dependencies will allow flexibility to course correct rather than postponing the spin-off. Standard practice is to target operational transfers for completion two months prior to the spin date, allowing for holding company steps to take place and providing a month or two of financial close.

Stranded and separation costs

Modeling stand-alone, one-time, and stranded costs

A structured and systematic approach to identifying and managing the costs of the separation should be undertaken. That helps to explain SpinCo's value, informs decision-making, makes for fruitful negotiations and positions RemainCo for success. Being proactive about identifying and managing transition costs can help the Parent improve the value of the deal.

SpinCo's financial statements are critical for giving a true picture of the business that's being spun. But they're equally important for the Parent, helping it to understand the cost of separating SpinCo and making it stand up as an independent operating entity.

Establishing a logical, data-driven point of view will help the Parent and SpinCo to align with each other more quickly. A detailed financial model not only captures generally accepted accounting principles (GAAP) and information about the deal, but also fully considers stranded, transition and one-time separation costs.

Stranded costs: Companies often don't appreciate the effect the separation will have on RemainCo's cost structure—or they're too late in beginning to plan for mitigating stranded costs. The costs attributed to SpinCo often aren't proportional to the percentage of revenue it contributes. With SpinCo not there to absorb previously shared costs, they become "stranded" with the Parent after the separation, denting future profitability.

One-time separation costs: Separation costs result from disentangling SpinCo from the Parent's infrastructure. These costs only need to be paid once across support functions to establish independent operations. To plan the separation approach, you need to understand what drives both one-time and run-rate costs. That will let you work out what it will cost to set up SpinCo. Fully understanding these cost implications usually means doing a significant amount of analysis.

Cost tracking (one-time and run-rate)

The costs involved in a spin-off are substantial. So a cost-tracking program should be a formal, embedded part of the SMO's ongoing responsibilities.

A cost-tracking program will help capture critical information, showing whether initiatives are meeting your financial targets. It's important to capture the right level of information, so that the executive steering committee and other key stakeholders get a pulse on costs. The cost-tracking program should include all three components we discussed: separation, TSA and stranded costs.

Ongoing cost management

Too often, companies fail to address cost-reduction opportunities effectively as part of the separation process. If the Parent doesn't eliminate stranded costs and optimize RemainCo's cost structure after the spin-off, that can drag down shareholder value. There may also be an opportunity to demonstrate a lower cost structure for SpinCo, which will increase its transaction value.

The SMO is in an excellent position to carry on managing cost-reduction efforts as part of the process of separation and carrying out the operational work plans.

Change, communications and culture

A spin provides an opportunity for companies to reinvent their employee value proposition, the culture and reengage stakeholders. Change, communication and culture planning goes beyond the close date. Have a roadmap in place that incorporates employee feedback and is agile enough to adapt as you implement and react to the reality of operating a new organization. An effective communication and change management program minimizes employee distractions that may result from uncertainty and fear and provides stakeholders (internal and external) with the right level of transition support. Communication and change management must consider key stakeholders to address, external and internal audiences, key messages and key timing to manage risks.

Stakeholder group	Planning considerations	Questions to be addressed
Employees	• Treat each employee stakeholder group differently and determine how their concerns will be addressed: Broad in-scope employee population, pivotal employees, executive team and managers. Outline what is changing, how things are changing, and when to expect changes to take place.	• Why is the spin-off happening? • Will I go with the spin-off company, remain or lose my job? • Will this change the way we do things? • What is the new target state operating model and how will it be implemented?
Labor	• Consider the current state of labor relationships at the divested company and competing negotiations that may hamper consultations • Understand legal notification requirements and required timelines	• Is there a potential buyer and what is the track record? • What is the impact on employee compensation and benefits? • Will there be redundancies for SpinCo and RemainCo?
Customers	• Messages to affirm customer benefits from the deal • Impacts on RemainCo business and how issues and concerns raised will be handled	• How will the change in ownership impact services provided? • Will current warranties still be in place? • Who do I contact if I have issues?
Vendors	• Critical contracts and legal obligations • Exposure for RemainCo and divested company due decreased purchasing power—economies of scale	• Who is the new owner and contracting legal organization? • What will be the impact on volumes or services provided? • Will new payment and quality requirements be put in place?
Media	• Deal value drivers for SpinCo and RemainCo • Impact on shareholder value and implications for employees, customers and community	• Will any jobs be lost or created as a result of the deal? • How will the deal impact divested business value? • What is the new organization called and where will it be headquartered?

Executing on a successful change and communications program during the spin requires planning proactively and executing with the long-term vision in mind:

- Establish a holistic and integrated strategy that incorporates change, communication and culture plan that accounts for external and internal stakeholders.
- Establish a clear CCC (Change, Communication, and Culture) governance with clear roles and responsibilities.
- Understand legal requirements and regulatory aspects of the deal and multijurisdictional implications and labor constituency requirements.
- Develop, agree and plan on key messages to support the deal early in the process.
- Align leaders at the top first, and then cascade down throughout the organization.
- Prioritize Day One requirements based on relative level of impact to stakeholder audiences.
- Determine and manage potential risks associated with in-scope employee transition and communications.
- Anticipate employee questions and proactively provide answers.
- Establish core communication processes, channels, frequency and timelines, and define communication roles and responsibilities.
- Quickly identify and execute timely on required training and knowledge transfer to close gaps—both for SpinCo and RemainCo.
- Focus on winning hearts and minds of employees to drive acceptance of the spin decision.
- Define the culture and key behaviors required for success of the individuals and SpinCo, define new ways of working.
- Identify any skills gap and create a training plan to transition knowledge from RemainCo employees to SpinCo employees.

The end goal in this phase is to lay the groundwork to ensure proactive change solutions and communications to minimize disruptions to the business, maintain employee focus and increase retention. The change and communication planning process must consider the correct timing of the initial communication for the different stakeholders and key groups, understand value propositions for employees and provide assurance through planned change levers and exciting new ways of working.

Optimizing while you separate and post-spin-off

Planning and identifying dependencies

A comprehensive process for planning the separation and transition is critical: one that makes sure leadership and key stakeholders agree on all aspects of the transaction, including strategy, transition objectives and execution. One of the key outputs is a preliminary definition of SpinCo, including the affected brands, processes, products, contracts, IP and people. This gives direction during the separation management launch. It also helps to see how complex and how long the transition timeline will be.

Day One planning starts with a separation kick-off meeting for all the affected business functions. After the kick-off, you should roll out tools, templates and processes to manage the separation. Areas covered in the planning process include:

- Vision and strategy
- Separation objectives, guiding principles, measures of success and timelines
- The SMO tools, templates and processes, as well as its reporting cadence and structure
- Dependency and issue management processes
- Each functional area's transition priorities

Putting the Day One work plan into action

Use the output from the separation kick-off and launch to create detailed separation work plans for the deal team and the functional areas that are affected. Develop draft work plans over the first few weeks after the launch and carry on evolving them over the course of the separation. These work plans focus on the tasks that need to be done to successfully separate the business and should help preserve value, mitigate risks and keep the Parent and SpinCo's operations going during the transition. These plans should also fulfill obligations to employees, customers and other stakeholders.

An effective SMO manages by exception. If the launch of the separation is a success, and if work plans are finely detailed, the SMO can move to an exception-based management approach. An SMO can follow this approach by using a few key processes, including making regular status reports as well as managing and tracking dependencies.

- **Status reports—**The functional teams report periodically, using standard templates. These capture the team's progress on key milestones, making decisions, resolving issues and managing cross-functional dependencies. The teams issue their reports every week until the transaction closes. After that, they're every two weeks or every month, depending on the level of transition services they're delivering and on how much RemainCo's operations need reorganizing.
- **Dependency management—**A dependency is when one functional area needs action, information or decision-making from another. Usually, the second functional area has to deal with the dependency before the first can carry on with part of the transition or separation. In a smaller spin-off, you might just need a simple dependency log. But in larger-scale and cross-border spin-off, you might need a more rigorous process and set of tracking mechanisms. In either case, the main goal is to make sure you identify and track dependencies so that they're easier to resolve and don't delay the deal.
- **Optimization and right-sizing—**Towards the end of the separation process, when SpinCo's standing on its own, it's important to assess the impact of the separation on the Parent. You should also look at stranded costs at the close and when TSA services expire. To optimize the Parent:
  - Understand the Parent's fixed, variable and mixed costs, so you can spot extra cost-cutting opportunities.
  - Assess areas that might not now be right-sized for supporting RemainCo. These include headcount, facilities, systems, infrastructure, and vendor and supplier commitments.

When the separation and transformation exercise is over, SpinCo's performance measurement offers the opportunity to optimize the revenues, capabilities and supporting cost structures. As part of this, the core business functions' key performance indicators should be analyzed, comparing them with the TOM designed in strategic planning. The analysis results in a lean and optimized SpinCo with:

- Right-sized corporate functions
- Efficient sales, general and administrative functions
- Economies of scale
- Minimized stranded costs for the Parent

For more information about driving value through divestitures and operational separation and TSAs, please contact:

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Functional separation and SpinCo stand-up

A successful spin-off requires careful planning. SpinCo must prepare its management team and business units to begin acting and functioning as a public company, both internally and externally. Although TSAs may be in place for a period of time while SpinCo gets stood up, a cross-functional, holistic view to readiness is critical to preparing the organization to operate as a public company.

Being public is the process of preparing the organization to operate as a public company. The many tasks involve upgrading, sustaining or enhancing financial reporting capabilities, creating an investor relations function and meeting the governance, reporting and internal controls standards and the listing requirements of the SEC and of the selected exchange.

In this section we cover:

Finance

Before you start the regulatory process for the spin-off, make sure SpinCo can handle its basic corporate functions as efficiently and easily as possible.

Planning ahead for the unique separation complexities of the finance function is critical to meeting your deal timeline.

Reporting as a public company

The spin-off is not the end of the SEC process—it is only the beginning. Once listed, SpinCo will be under a heightened level of scrutiny and will have a range of continuing reporting obligations, including annual filings on Form 10-K, quarterly filings on Form 10-Q and event-driven filings throughout the year on Form 8-K. Understand what is required early so you can plan ahead.

Parent accounting for the spin-off

The Parent must plan for various financial reporting requirements after the spin-off is completed, including held for sale and discontinued operations analyses and, in many situations, pro forma financial statements reflecting the disposition within four business days of the spin-off. The disposition pro forma financial statements may require additional reporting requirements if the SpinCo qualifies as a discontinued operation.

Internal controls and risk management

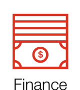
SpinCo will have to pay special attention to rules outlining internal controls and corporate responsibility, transparency, and behavior, among other things.

Treasury, Tax, Information technology and Human resources

We discuss the additional considerations around these functions to set you up for a successful separation.

Here is a typical illustration of various items that need to be addressed to stand-up SpinCo to be able to operate as a newly public company.

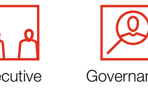
Accounting and financial reporting


Finance effectiveness

Internal controls

Tax

Executive compensation and HR


Governance and leadership

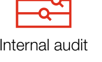
Financial planning and analysis

Treasury

Legal

Internal audit

Engage with investment banks


Media and investor relations

Enterprise risk management

Corporate strategy and development

Wealth management planning

Finance

Finance is a basic corporate function. You'll have to decide how to handle these tasks for SpinCo in a way that's most efficient. For example, do you have the right resources and will you do it all in-house? Or will you outsource some functions?

Find out what works best for SpinCo. You'll prepare by tackling issues like how to structure the organizational chart and planning for separation. You then move on to setting up a management reporting structure and establishing a framework for following rules prescribed by the Sarbanes-Oxley Act. The following are discussed in further details in this section:

Finance organization structure

Before you start the regulatory process for the spin-off, make sure SpinCo can handle its basic corporate functions as efficiently and easily as possible.

Separation considerations

Planning ahead for the unique separation complexities of the finance function is critical to meeting your deal timeline.

Establishing management reporting

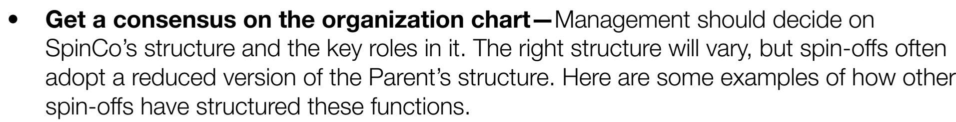
Choose the best way to measure and report results and performance. That will maximize insights and help your organization understands where to allocate resources for the greatest benefit.

Finance organization structure

For the new management team, one of the first things to decide is the right size and structure of the corporate functions. In today's competitive environment, cost pressures mean that recently restructured companies need to keep their corporate staff lean while also addressing the additional requirements of being a stand-alone business, such as external financial reporting requirements. Some spin-off companies set a headcount goal for all corporate functions and attempt to internally staff according to the established goal. Other companies outsource activities like IT, payroll or benefits management. Both these approaches help prioritize key functions and prevent overstaffing at the start.

To begin the planning process, key areas to consider include those below.

- **Look for possible changes—**You should look across all corporate functions and find places to make changes. You can do this by:
  - Running a benchmarking analysis to find opportunities and help prioritize changes. For example, look for ways to reduce headcount, introduce automation or improve processes.
  - Understanding each role for every process at each employee level, ranking the value they bring to that process
  - Doing a gap analysis of each department to understand how well it has been done in the past and how it could improve



- **Get a consensus on the organization chart—**Management should decide on SpinCo's structure and the key roles in it. The right structure will vary, but spin-offs often adopt a reduced version of the Parent's structure. Here are some examples of how other spin-offs have structured these functions.
  - The finance director or controller for each operating division usually reports to operating management. Often, they have a dotted-line reporting to the corporate chief financial officer or controller.
  - Most treasury functions are centralized, even if the rest of the company is decentralized. The corporate treasury function often manages cash, arranges outside financing and acts as banker to the operating units.
  - Large corporate functions (like controller, tax director, treasurer, internal audit, information systems, investor relations and human resources) usually report to a specific person, often the CFO or an executive vice president. In turn, this person reports to the CEO. In some companies, the tax function reports to the treasurer or the controller. Others have investor relations reporting directly to the CEO.
- **Plan your top priority functions—**Prioritize SpinCo's top functions, then decide on the right people to fill them. Many companies see the CFO, corporate controller, treasury and investor relations functions as the top priorities. For other functions, SpinCo can either outsource or share them with the Parent. For example, while the internal audit director is an important role, it's not usually key to becoming a stand-alone company. Instead, SpinCo can get this service from the Parent or a third-party when it needs it.
- **Plan the second-priority functions—**SpinCo will then need to fill other functions that aren't top priority but that it still needs to have in place by the spin-off date to be able to operate on its own. Depending on what SpinCo has decided for the role of the CFO and other priority functions, these could include support functions like the internal audit director, controller and director of financial reporting. Over time, you can pinpoint and staff any other corporate functions, like internal audit and support staff. Again, you should decide which roles to staff in-house and which to outsource.
  - Companies should consider their risk appetite and compliance structure to make sure it's effective and meet their overall objectives. Best practice may include three lines of defense in an organization where it is the primary means to demonstrate and structure roles, responsibilities and accountability for decision-making, risk and control to achieve effective governance, risk management and assurance. The following is a high level explanation for each line of defense.
    - First line of defense (risk owners)—Responsible for deploying strategies (taking risk) to generate reward for the organization and for managing risks to acceptable levels
    - Second line of defense (risk programs and oversight)—Responsible for developing, implementing and monitoring programs to support risk owners
    - Third line of defense (internal audit)—Responsible for independently assessing management's processes to manage and monitor risks

Depending on what bridging or transition service agreements SpinCo has, and how much it uses outsourcing, it will need support staff for its administrative and support functions. For the Parent company, the spin-off is an opportunity to streamline its administrative operations and lower headcount. SpinCo and the Parent should consider working together to decide on their needs and agree on which support staff will work for SpinCo after the spin-off.

Separation considerations

Finance is a key function for any separation due to its responsibility in maintaining business critical processes, such as payroll disbursements, collections, billings, procurement, controls, and continuity of financial reporting. It is critical to develop a comprehensive separation plan that covers critical finance processes, identifies long-lead time activities and considers cross functional dependencies.

The planning process for finance transition and separation ensures that the leaders of the Parent and SpinCo are aligned on everything from deal strategy to transition objectives and execution. The output of the transition-planning phase will give the transition's launch the direction it needs, as well as providing the input for the transition workstreams. You need to understand the separation's impact across the enterprise as well as the Parent and SpinCo's priorities. That will enable you to plan effectively and spot hurdles early on.

- **Rapidly assess the finance function—**Find opportunities for improvement and challenge the stand-alone finance function's costs and performance. Do this by assessing cash and liquidity management, financing arrangements and financial risk management.
- **Find areas where the separation will be complex—**Work out how independent finance systems are and how many dedicated finance staff SpinCo will need. Also see how independent it will be from an external perspective, including its tax and legal-entity structure and third-party contracts.
- **Develop a practical implementation plan—**Estimate costs for the finance function and TSA as well as stranded costs during the transition. And look at management's expectations for delivering TSA services.
- **Develop a vision for finance—**This is the finance target operating model and TSA migration. The separation impacts across key business processes should be understood—both for Day One and for TSA exit. Key elements of the finance target operating model should define:
  - Fit-for-purpose processes and supporting systems
  - Whether to take an insourcing or outsourcing approach
  - Roles, responsibilities and required capabilities
  - An implementation plan for the target operating model
  - A plan for moving off the TSA

Considerations for finance separation can be organized in six broad areas:

One-time, standalone, and stranded cost model

- Develop overall budget for one-time separation costs and track it against actuals
- Develop standalone cost profile for SpinCo
- Leverage transaction perimeter, TSA costs, and historical allocations to develop stranded cost model

Day One separation plan and execution

- Define treasury, AR, AP, credit and collections, billing, general accounting, and other transactional and process separation requirements
- Develop and manage separation work plans and identify dependencies and critical path requirements
- Support in assessing systems, processes, and resources to meet separation requirements for financial transactions and financial reporting

Legal entity financial separation

Step plan accounting

- Develop and prepare accounting entries for each transaction type in the step plan
- Coordinate with Legal to ensure legal documents are executed

Intercompany settlement

- Develop settlement strategy by jurisdiction and intercompany type (internal and external loans, trade AR/AP) and prepare accounting entries

Post close clean-up and optimization

- Clean-up of Legal Entities, I/C, Ledgers, etc.
- Manage the TSA exit process, including execution and coordination of SpinCo cutover plans, reporting on bleed-out progress and final close-down activity
- Assist with stranded costs management—org design , systems, process rationalization
- Update management reporting, related systems and master data

Finance TSA scope and service delivery

- Per Day One separation strategy, prepare detailed service schedule and costs for various finance and accounting services
- Develop process to deliver TSA services
- Develop a mechanism to track, invoice and collect TSA costs

Deal deliverables at close

- Assist with closing balance sheet process
- Calculate working capital at close to estimate cash requirements at country/Legal entity level
- Develop and execute "Net Economic Benefit" model for the delayed/local close

Under operations separation and optimization, we covered one-time, stand-alone, and stranded costs. Finance is heavily involved in those activities, especially in providing inputs regarding separation complexity, existing allocation methodologies and the identification of various cost pools.

We also discussed TSAs and post-close optimization. During TSA development, Finance is responsible for working with the central TSA team to identify and develop the schedule of TSA services within the finance function.

During TSA Costing, Finance provides critical inputs (e.g., baseline costs) to all functions and reviews the cost models to refine and finalize service costs. As TSAs get operationalized, Finance supports the invoicing of TSA fees, among other financial aspects.

In the next few pages, we will cover Finance separation planning and Day One readiness, and the establishment of a separation balance sheet including movement of financial balances as part of legal entity separation.

Day One financial separation readiness—scope of activities & cross functional collaboration

Before beginning detailed separation planning, it is important to outline the complete scope of separation activities and highlight inbound and outbound dependencies:

Financial separation—scope

The scope of all separation activities in the finance function can be split into process-based activities or function-specific activities. For each of these activities, a reasonable separation approach needs to be established, in order to determine which activities will be completely separated by Day One, and which activities may remain commingled for a duration of time between Day One and TSA exit. For any activity that remains commingled, RemainCo will have to provide sufficient support until the activities are fully separated.

Process-based activities

Order to cash

- Business model and customer integration strategy
- Quoting, credit and contracting
- Ordering/fulfillment and master data management
- Invoicing and revenue recognition
- Accounts receivable and collections

Procure to pay

- Sourcing and procurement (direct and indirect)
- Policies, authorizations, and controls
- Fixed assets and CAPEX
- Inventory accounting and management
- Accounts payable
- Sourcing and procurement synergies
- Integration to/from 3rd parties

Hire to retire

- Stock conversion and equity awards
- Payroll transition, including compensation, benefits, commissions and bonuses
- Travel services and corporate cards
- Expense management and policy alignment
- Pension plan obligations and funding requirements

Record to report

- Chart of accounts and close calendar alignment
- Financial consolidation
- Contingency plan for mid-month close
- Fair value of acquired assets and liabilities
- Opening balance sheet
- Push down accounting requirements
- Reporting requirements and disclosures (including business segments)
- Intercompany accounting process

Function-specific activities

Tax

- Acquisition structure and step plan
- Future state tax planning and restructuring
- Focus on FIN 48 exposures
- Impact of potential dispositions of non-core operations
- Maintaining ongoing tax compliance
- Legal entity mergers and rationalization

Internal controls and compliance

- Accounting policies and procedures alignment
- Risk assessment and controls alignment
- 302 and 404 certification processes
- Other compliance requirements (e.g., FCPA, PCI, HIPAA, GDPR, ECA, Basel II, FDA)
- Internal audit and enterprise risk management
- Training and tools

Financial planning and analysis

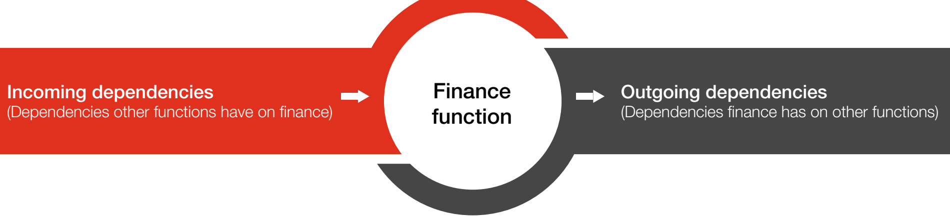
- Performance management framework, agreed KPI definition and monitoring
- Budgeting and planning, including strategic plan, annual operating plan and quarterly forecast
- Management reporting alignment
- Operational analysis and reporting
- Cost center alignment
- Decision support tools and techniques
- Synergy identification, review and tracking

Treasury

- Assume control of cash
- Ensure cash and liquidity is sufficient and forecasts are linked into broader reporting
- Optimize external capital sources and monitor compliance
- Ensure intercompany funding is deployed
- Financial risk management (hedging programs, foreign exchange and commodity exposure)
- Treasury controls/systems are in place
- Treasury policies and procedures current and effective
- Insurance coverage is optimized

Cross functional dependencies

Several key functional separation activities for finance are dependent on coordination with other functions.



	Incoming dependencies	Outgoing dependencies
HR	• Parallel payroll processing (including compensation and benefits) and HC costs • Creation of ERP/HRIS cost centers and company codes (HR/IT)	• FTE count for management reporting and budgeting • Requisition management/ staffing forecasts
IT	• Data conversion requirements between RemainCo and SpinCo systems • Inventory all applications used by Spinco Finance and map to SpinCo Systems • Identify data storage, interfaces and related infrastructure requirements	• Access to SpinCo financial and enterprise systems • Systems and tools needed for planning and budgeting • Determine data retention plan for Target payment details, images • Set up SpinCo's Finance users in SpinCo's finance systems
Legal	• Modified vendor agreements (together with Procurement Function)	• Legal entity structure for tax obligation forecasting and operational planning • Reporting systems and registrations, licenses, and permits • Assignment of officers
Sales	• Standard credit policies	• Revenue synergy • Pricing policy
Operations	• Cash management policies	• N/A
All functions	• Integration cost tracking and integration budget approval • New intercompany transactions	• Support for synergy calculations

Month-end close process

One of the most important functions performed by finance is the month-end close process and the resulting financial reporting. It is expected that the month-end close process for SpinCo will be different after the separation. As part of separation planning, it is advised that the entire month-end close process is documented and one or more dry runs performed to identify and remedy any knowledge, capability, or skill gaps. The dry run(s) should be performed in close collaboration with IT to ensure that the proper configurations are in place to support the month-end close.

Day One separation balance sheet (SBS)

Establishing the separation balance sheet in SpinCo's ERP is critical in getting ready for financial reporting. Day one SBS scope covers systems, legal entities, and accounts. For global spin-offs, considerations need to be addressed for US GAAP and Local GAAP financials.

Key considerations

All SpinCo vs. shared with RemainCo	Reference legal entity scoping (wholly SpinCo us shared) per deal perimeter and analyze balance dispositions, etc.
Accounts	Scope on deal perimeter as well as nature of balances US GAAP vs local GAAP: Prepare central reporting in accordance with US GAAP and identify any needs and deviations for local GAAP in regional reporting
Systems	Consider RemainCo environment (Reporting/Consolidations) and determine which systems will be used by SpinCo

Key guiding principles

The separation balance sheet is one of the important deliverables that the Parent typically agrees to prepare for the SpinCo to establish its opening balance sheet. Preparing the separation balance sheet can be a complicated activity and is dependent on multiple cross-functional considerations. The baseline and the accounting methodologies from SpinCo's carve-out financial statements have a direct impact on the separation balance sheet. It is important to follow the following key guiding principles to streamline the process:

1. SBS remains in US GAAP as of legal separation and local GAAP for each legal entity based on respective local requirements
2. US GAAP SBS follows the standardized methodology presented by account sub-component. Exceptions to SBS methodologies and go-live dates must be communicated and managed centrally
3. Historical carve-out methodologies will be leveraged as the basis for SBS account methodologies, where applicable
4. Where possible, the creation of the opening balances will be systematically driven, minimizing the volume of manual entries required
5. SBS creation will be enable by prior identification of SpinCo balances within the RemainCo ledger, where possible

Key considerations

The key considerations related to separation balance sheet readiness activities are presented below.

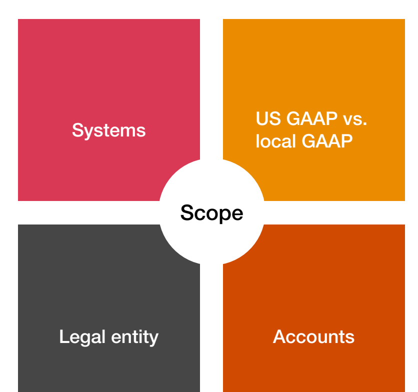
Timing of entity close	Not all the markets/LEs may close at global close, hence the timeline and "effective" date of separation would dictate the timing of preparing US GAAP and local statutory separation balances sheets
Tax step plan/LE listing finalization	Tax step plan/LE listing finalization will identify new LE stand-ups, plus provide guidance on assets and liabilities to be transferred over to SpinCo
LE directionality	Assuming that the LEs will be created for SpinCo wherever there is a "mixed use" entity. Hence Spin Co balances would be moved out of the existing LEs and into the new LEs. However, in instances where new LE is RemainCo, Remain Co balances from existing LE will be moved into new LE
Closing carve-out financial statements	Carve-out financial statements will provide baseline data for the separation balance sheet. Timing of posting separation journals is dependent on availability of carved-out information
IT readiness	Posting separation BS journal entries to depend on ERP cutover readiness which includes cloning the new ERP (SpinCo) and setting up appropriate LEs. Completeness of system (HFM/ERP) units with SpinCo balances considered as part of the system cloning/separation. Consider having this workstream plugged into IT readiness workstream

Legal entity financial separation

Creation of standalone legal entity structure for SpinCo often requires execution of a detailed tax step plan, legal step plan and treasury funding plan. The financial and accounting impact of the various steps in these plans, including any intercompany "clean-up," need to be recorded in the ERP systems. This leads to separation of balances within RemainCo and SpinCo legal entities.

Similar to SBS, the scope of legal entity financials separation includes systems, legal entities, and general ledger and statutory accounts for US and Local GAAP.

The scope for the systems during the legal entity financial separation is accounted for at the ERP level



There may be differences in accounting treatments between US GAAP and local GAAP. In addition, specific local jurisdictional filings may be required

Legal entities that are in scope for the separation will be noted in the tax step plan. Some LEs will be dedicated (i.e., share transfer) while others will be shared/ commingled (i.e., asset transfer)

Below is a list of common accounts that are involved in the typical legal entity financial separation

- Cash
- Receivables and payables (e.g., trade, notes, interest, inter/intra)
- Taxes payables (e.g., income tax, withholding tax, VAT)
- Equity such as investment in subsidiary, common stock, share capital, additional paid in capital, retained earnings
- Dividends income and dividends declared

One of the key considerations in the movement of balances between legal entities as a result of the legal entity separation is the transaction type. Here is a list of some of the more common transaction types:

Transaction type	Definition
Asset transfer—Sale	When assets are sold from one legal entity to another, the seller receives cash from the purchaser with an offsetting reduction in assets sold
Asset transfer—Contribution	When a legal entity contributes assets to a subsidiary, it essentially transfers net assets in return for an increased investment in the subsidiary that receives the assets
Asset transfer—Distribution	When a legal entity distributes assets to a Parent company, it essentially transfers net assets in return for an increased investment in the subsidiary that receives the assets
Stock transfer—Sale	When a legal entity is sold from one shareholder to another, the expectation is that the legal entity will be transferred intact without any balance sheet changes
Stock transfer—Contribution	In the case of share contributions, the balance sheet of the "contributed" company will generally move "intact" from the original shareholder to the new shareholder
Stock transfer—Distribution	In the case of share distributions to a Parent Company, the balance sheet of the "distributed" company will generally move "intact" from the original shareholder to the new shareholder
Demerger	The assets, liabilities, contracts, and employees of a separate line of business (going concern) is transferred to a new legal entity by operation of law. Can be taxable of tax-free

Treatment of intercompany balances

A somewhat overlooked, yet critical component of the Day One readiness for finance is the resolution of intercompany balances between RemainCo and SpinCo just before the spin-off. The final balances as of Day One would need to be settled with appropriate "due to" and "due from" accounting or written off. See below for an illustrative example of how to treat intercompany balances and the associated complexity.

Legal entity scope	Trading partner scope: Dedicated SpinCo	Trading partner scope: Shared	Trading partner scope: Dedicated RemainCo
Dedicated SpinCo	Cash settled (Low)	Cash settled (Moderate)	Cash settled (Low)
Shared	Cash settled (Moderate)	Cash settled (High)	Cash settled (Moderate)
Dedicated RemainCo	Cash settled (Low)	Cash settled (Moderate)	Cash settled (Low)

Complexity level: High / Moderate / Low

Establishing management reporting

After the spin-off, the management reporting function of SpinCo will need to operate accurately and efficiently. Consider the following.

- Spin-offs are a good opportunity to set new or revised management reporting to best suit the needs of a stand-alone company. You should decide on the best ways to measure and report results and performance.
- When establishing metrics for management reporting, think carefully about internal reporting needs. These metrics drive the performance metrics that SpinCo includes in the MD&A section of its annual and quarterly SEC filings. They also inform how SpinCo will report its segments.
  - Management should carefully consider the structure and form of its management reports to ensure they include the appropriate level and types of disaggregation that will be used to assess the performance of the business on an ongoing basis and allocate resources.
  - In doing this, you will want to avoid having to significantly change internal management reporting which may result in different reportable segments as well as different reporting metrics within MD&A.
- Along with management reporting requirements, you should think about how to analyze competitiveness in the market and benchmark against peers.

For more information about driving value through divestitures and operational separation and TSAs, please contact:

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Reporting as a public company

As soon as the registration statement is declared effective, SpinCo will have the same reporting requirements of a stand-alone, public company. As noted previously, preparing to meet these reporting requirements should be a focus for the SpinCo as it files periodic financial information with the SEC. SpinCo should discuss their obligations under the various regulations with their attorneys and accountants at the beginning to lay out the obligations and ensure they can be met.

- **Understand your reporting obligations—**Once the registration statement is declared effective, SpinCo will be required by the SEC under the Exchange Act to file periodic reports to keep the investing public informed of SpinCo's financial position and results of operations.
  - The SEC has amended its disclosure requirements that are required in many registration statements and SEC filings including Form 10-K. These amendments are related to the description of the business, legal proceedings and risk factors. Refer to PwC's In Depth *Navigating the SEC's Amended Regulation S-K disclosure Rules* for additional information.
  - SpinCo should consider the growing expectations by investors and public company reporting requirements by the SEC around Environmental, Social, and Governance (ESG) disclosures. The SEC has recently introduced new disclosure requirements for registrants to provide stakeholders with insights into companies' human capital-from the operating model, to talent planning, learning and innovation, employee experience, and work environment. For more information, refer to PwC's *In the Loop New Human Capital Disclosure Rules: Getting Your Company Ready*.
- **SEC-designated filer status—**The SEC designates companies into certain categories of filers to determine filing deadlines for Forms 10-K and 10-Q, among other things, including accelerated, large accelerated, EGC, smaller reporting company and non-accelerated filer status. The distinction is based on, in part, the non-affiliated (i.e., excluding large institutional investors, directors, officers, etc.) market capitalization (also known as "public float") of companies as of the last business day of the company's most recently completed second quarter. You should discuss your categorization in detail with your counsel and accountants. However, the general guidelines are presented in the table below.

  The table below also presents the interaction between the classification of Smaller reporting companies (SRC) and Non-accelerated, Accelerated and Large accelerated filers:

Status	Public float	Annual revenues
SRC and Non-Accelerated filer	Less than $75 million	N/A
	$75 million to less than $700 million	Less than $100 million
SRC and Accelerated filer	$75 million to less than $250 million	$100 million or more
Accelerated filer (not SRC)	$250 million to less than $700 million	$100 million or more
Large accelerated filer (not SRC)	$700 million or more	N/A

Note that companies will generally be considered non-accelerated filers in the first year as a public company, as they have not met the filing requirements to be an accelerated filer. The requirements are calculated at the fiscal year-end and a newly public company would generally not have filed an annual report for the prior year. There are, however, limited exceptions to this and the final determination should be confirmed with internal and external legal counsel. Accelerated filer status must be considered each year to determine whether the designated filer status has changed.

SpinCo is required to file its first Form 10-Q within 45 days of either the end of the quarter that includes the spin-off, or the date the Form 10 was declared effective, whichever is later.

Once the SpinCo is a registrant and has filed its own Form 10-Q, RemainCo should consider the need to report information about SpinCo in the context of ASC 205-20 as a discontinued operation on a recasted basis in its recurring filings and future registration statements. Refer to the section below for additional information on discontinued operations.

Below is an overview of certain standard SEC forms and other requirements for public companies based on filer status. This is not an inclusive list, but provided for illustrative purposes.

Form	Description	Due date based on designation
Form 10-K	This is the annual report to shareholders (conforming to SEC specifications) and it discloses detailed information about the company's activities, risks, financial condition and results of operations. It also contains the company's audited annual financial statements, which include the external auditor's opinion of financial statements and Section 404(a) of SOX (only required when filing the second Form 10-K after going public) and 404(b) (required based on the registrant's filer status).	• Large accelerated filer-60 days after fiscal year end • Accelerated filer-75 days after fiscal year end • Non-accelerated filer-90 days after fiscal year end • Newly public company-90 days after fiscal year end
Form 10-Q	This is the quarterly report required for each of the first three quarters of the fiscal year. It includes condensed financial data and information on significant events. In addition, SEC rules require that the interim financial information included in the quarterly report be subject to a review by an independent auditor prior to filling.	• Large accelerated filer-40 days after fiscal quarter end • Accelerated filer-40 days after fiscal quarter end • Non-accelerated filer-45 days after fiscal quarter end
Form 8-K	This is a report filed for significant events such as an acquisition or disposal of assets; a change in control; bankruptcy; a change in independent auditor; resignation of directors because of disagreement with the registrant; the entry into a material definitive agreement; creation of direct obligations or obligations under off-balance sheet arrangements; a commitment to a plan involving exit or disposal activities; asset impairments; and when a company concludes, or is advised by its independent auditors, that previously issued financial statements should no longer be relied upon.	• Due within four business days of event
Proxy information	This contains data furnished to shareholders so they can decide how to assign their statements' proxies (votes).	• Due dates vary

Parent accounting for the spin-off

In preparation for the divestiture transaction, the Parent should consider its own accounting and reporting requirements in preparation for and after the separation of SpinCo.

- **Held for sale and discontinued operations presentation—**The Parent should consider if the SpinCo meets the criteria to be classified as held for sale and further, whether the SpinCo will represent a discontinued operation. In determining if the SpinCo meets the held for sale criteria, the Parent should consider the guidance at ASC 360, *Property, Plant, and Equipment,* and classify the disposal group as held for sale in the period in which all criteria are met. The criteria for held for sale and/or discontinued operations treatment are not met in a spin-off until the spin-off is completed. After the spin-off, the assets can be classified in the balance sheet as assets held for spin (as opposed to assets held for sale).This determination of when the criteria is met can be different in a sale or split-off transaction, so careful consideration should be given related to this topic.

  The Parent is not required to retroactively reclassify the disposal group as held for sale in periods prior to the period in which the disposal group becomes held for sale unless the disposal group qualifies as a discontinued operation.

  The Parent should consider the guidance of ASC 205, *Discontinued Operations,* and assess if the SpinCo represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. The results reflected in the stand-alone historical carve-out financial statements of the SpinCo will not agree to the discontinued operations presented by the Parent. When reporting discontinued operations, the Parent should report the results of the disposal group, less applicable income taxes (benefit), as a separate component of income before cumulative effect of change in accounting principles (if applicable). Costs associated with the exit or disposal of the discontinued operation should be included as well as any impairment losses recognized under the held for sale model that directly relate to the disposal group. The expenses that qualify for inclusion are the direct operating expenses incurred by the discontinued operation that may be reasonably segregated from costs of the ongoing reporting entity. Indirect expenses, such as allocated corporate overhead, should not be included in discontinued operations. Accordingly, the income statement effect reflected by the Parent will be different from the carve-out financial statements prepared for SpinCo.

- **Other RemainCo accounting considerations—**The Parent should consider other accounting and reporting matters when preparing for the spin-off to get ahead of analyses that will be required post-separation. These include considerations such as RemainCo's analysis of its post-separation derecognition of goodwill and related impairment testing upon spin-off (where applicable), potential changes to reporting units and reportable segments, derecognition of CTA balances and equity balances (where applicable).

  Additional accounting assessments should be considered for any new agreements or modifications to existing agreements in connection with the spin-off (with third parties - including SpinCo), for example, leases, stock compensation schemes, tax and other indemnifications and guarantees.

- **SEC reporting requirements—**The Parent should consider SEC reporting requirements regarding the spin-off of its business. Specifically, if the spin-off exceeds 20% significance based on the asset, investment or income tests in S-X Rule 1-02(w) of Regulation S-X, the Parent is required to file a Form 8-K within 4 business days of completion of the spin-off. The 20% threshold is a change from previous rules that required only a 10% significant disposition to trip the requirement to include pro forma financial statements in a Form 8-K filing. Refer to the section P*reparing the Registration Statement and Carve-out Financial Statements for SpinCo* for more information around the amended rules for S-X Rule 3-05 and S-X Article 11.

The Form 8-K should include pro forma financial information required by Article 11 of Regulation S-X that gives effect to the spin-off, if the spin-off is not fully reflected in the Parent's historical financial statements. Pro forma data is still necessary even if discontinued operations criteria are not met, however the periods presented in the pro forma financial statements will vary from a scenario where the disposal met the criteria of ASC 205-20 (Discontinued Operations).

Note that there is not a 71 day extension for the Form 8-K reporting a significant disposition, unlike the relief provided for a business combination. If the spin-off triggering the Form 8-K filing requirements qualifies as a discontinued operation, three years of annual pro forma income statements plus the most recent year-to-date interim period are required (two years for a SRC), as well as a pro forma balance sheet for the most recent interim or annual date reported by the Parent. Pro forma footnote disclosures would also be required in such filing. In contrast, if the spin-off does not qualify as a discontinued operation, but meets the 20% significance threshold of a significant disposition, then only one annual pro forma and the most recent year-to-date income statement for the interim period, as well as a pro forma balance sheet for the most recent interim or annual date reported by the Parent, is required. If the spin-off is reflected in the most recent balance sheet of the Parent as a consummated disposal, such pro forma balance sheet information would not be required in Form 8-K. However, this circumstance is rare in practice.

For more information on delivering value on your divestiture, reporting as a public company and Parent accounting for the spin-off, please contact:

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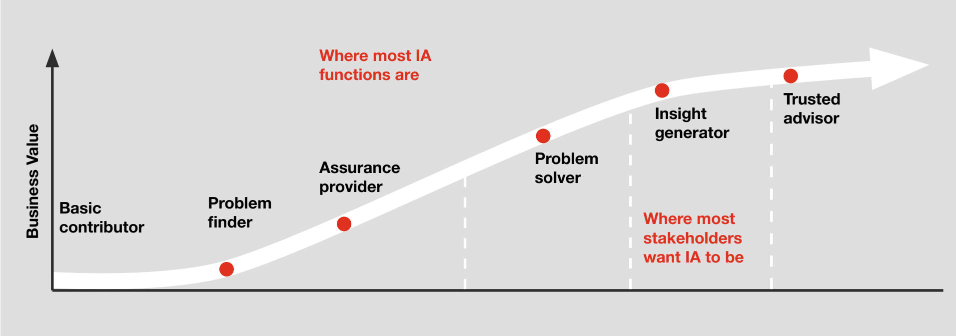
Internal controls and risk management

Establishing an internal audit function

SpinCo can choose to outsource or set up its own internal audit department. It can play a valuable role in internal governance, including watching over risks and controls. It can also act as an in-house consultant that tracks the progress and effectiveness of key business goals. Internal audit can help management meet many strategic challenges, from assessing the reliability of financial data used in decision-making to focusing on how the organization uses resources. All of this can help you increase quality, productivity and profits.

- **Public company trends—**In the past, many public companies used an internal audit function to provide management and the audit committee results of ongoing reviews of risks and internal controls. More recently, companies have started to ask more of internal audit. Internal audit's maturity as an assurance provider can vary depending on the strategy, structure, people, use of technology and process implemented by the SpinCo. The business value gained from the services offered by internal audit increases as the function matures from a problem finder to a trusted advisor.
- **Options for internal audit—**To set up an internal audit function, you have several options. You can rely on the Parent for transition services. You can outsource to a third party. Another option is to set up your own stand-alone internal audit function led by a chief audit executive appointed by the audit committee.



Sometimes, stock exchanges require that companies also have an internal audit function. The NYSE gives companies listing in connection with a spin-off a one-year transition period to follow its requirements for an internal audit function. But other exchanges (like Nasdaq) don't explicitly require internal audit functions.

To plan for the spin-off, there are several key decisions to be made.

- **Prioritize internal audit—**You'll need to decide if internal audit is a top priority and if SpinCo needs a single person or a group to fill key roles, like the internal audit director. If internal audit is lower priority, you can at least start to understand the options for this function in the short term (before the spin-off), medium term (within one year of the spin-off) and longer term (after one year). SpinCo might decide to rely on the Parent for transition services, outsource to a third party or in-source with strategic hiring.

  Additional thought will need to be given to the go-forward structure of the internal audit department and interim reliance on the Parent for assistance for a period of time post-spin-off, if applicable.

- **Design an internal department—**A key decision that will need to be made is how to set up and structure the internal audit department. To do this, SpinCo can partner with the Parent in a transition services agreement, set up its own internal audit department or outsource to a third party. This transition is a great time for management to identify what value internal audit can bring and to figure out the right skills and staffing model to get there. Here are two common examples.
  - **Rotation model—**Many companies decide to use the internal audit department as a development opportunity for employees. So they might regularly rotate employees in and out of the department, often for a stint of two to four years. This approach benefits both employees and the department. Employees get valuable experience in how the company works which they can take to a new position in the organization. The internal audit department gets a stream of new insights. The main downside to this approach is that it can affect continuity in the department.
  - **Permanent hires—**A second approach is to hire people into the department permanently. In other words, transfers to and from the department aren't the norm. This approach helps preserve continuity and keep significant audit experience in the department. But, given the nature of audit work, companies also need to keep people motivated and challenged to reduce the chance of complacency and too much turnover. Many companies find that if they define clear career paths in the department and offer meaningful training programs they can hold on to more employees.
- **Outsource internal audit—**Many companies decide to outsource all or part of the internal audit function. The primary advantage to outsource services is to leverage outside expertise and obtain different perspectives on latest trends and focus areas. Here are some ways to do this.
  - **Co-sourcing—**Companies hire internal audit service firms to plan, coordinate and supervise assigned internal audits. Co-sourcing offers SpinCo the flexibility to delegate more complex, specialized audits to outside firms and have internal resources focus on higher priority projects. In some cases, SpinCo may offer resources to work under the internal audit service firm to learn and train on new techniques and audit approaches.
  - **Staff augmentation—**This is where a company has audit staff that works under the company's internal audit leader (like a chief audit executive). This staff carries out the more standard types of audits.
  - **Hybrid—**This is where companies blend both approaches either as a co-source model or through staff augmentation depending on the project.

More often than not, companies use a combination of various sourcing techniques to establish their internal audit functions. Even in cases where the majority of work is being sourced internally (rotational or permanent hires), subject matter specialists are procured through a co-sourcing or staff augmentation model.

Post spin-off, SpinCo will need to spend additional time on key areas that aren't critical to stand up during the separation process. These considerations include the following:

- **Develop a charter or mission statement—**You should create a charter or mission statement that explains what internal audit does and what its goals and priorities are. SpinCo can use this same document from the Parent. But it can also tailor it to its own needs, which might be different. In this document, explain how the company evaluates internal audit performance. Then approve it with senior management and the board.

  An effective mission statement or charter also shows how internal audit fits in with the priorities of senior management and the audit committee. Although these documents vary in length and detail, they should cover how much time the internal audit function spends on traditional audits (assurance-focused and internal control) compared to consulting activities that can add value to lines of business. If the document doesn't match stakeholder expectations, it's of little value and might not help to enhance performance.

  Be sure to include internal audit's:

  - Purpose, role and mission
  - Responsibilities, referring to the applicable audit framework(s) you use
  - Objectives, and how they relate to SpinCo overall
  - Authority, including access to SpinCo's records
  - Organizational framework, including independence and objectivity
  - Alignment with the audit committee charter where internal audit is mentioned
  - Reporting requirements and monitoring process

- **Create a strategic plan—**A strategic plan will develop the internal audit function. It should be more than a point-in-time risk assessment. In this plan, you should:
  - Define the value of the new internal audit function, the customers it serves and the value it will create
  - Outline operational tactics to achieve key goals
  - Set out functional management responsibilities
  - Show funding and staffing needs for the immediate future and the next three to five years
  - List key assumptions and benchmarks that compare the plan against third-party data
  - Consider the costs and benefits of using different approaches to get the desired results
  - Make a communication plan, which is vital for the function to work. This can include topics like:
    - How the audit committee and executive management will communicate to the rest of the company about internal audit's responsibilities and authority
    - How SpinCo should support the mission of internal audit
    - How SpinCo will remediate any internal control weaknesses or issues that an internal audit finds

Ultimately, the strategic plan sets the standard for how SpinCo can make decisions and measure results. We recommend you review this plan every year and have key stakeholders approve any proposed changes.

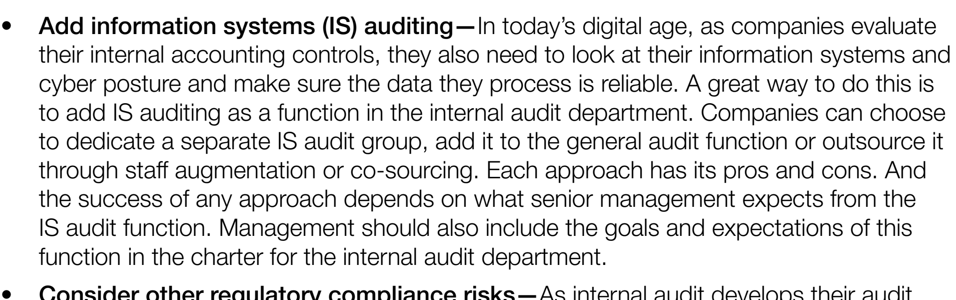
- **Assess risks and create an audit plan—**Auditors use risk assessments to estimate if a potential event might slow or prevent the company from meeting its goals. To get started, an auditor should define the audit universe, which includes all business units, processes and operations. Next, the auditor should understand the company's business model in the context of its industry and its key business goals. By talking with key stakeholders, internal audit should become familiar with the audit universe, key business goals and risks that come with meeting those goals.

  The auditor then considers how various risks might prevent the company from meeting its goals (and how likely these are to happen). As part of your audit plan, auditors should consider all types of risks, from financial to operational to compliance. By doing this, the auditor can create a risk profile for SpinCo and share it with management and the audit committee, perhaps using a heat map that shows high, moderate and low risk areas.

  Risk assessment is internal audit's identification (or validation) and prioritization of the organization's risks from internal audit's perspective, independent of other risk assessments done by the business or other assurance functions. Internal audit responds to the risk assessment by using the results to develop a formal audit plan. Audit plans are created each year to ensure existing risks are validated, new risks are identified and confirming previous risks are no longer applicable. While audit plans are tailored to the specific company and industry, all audit plans cover risks associated with financial, operational and compliance/regulatory impacts. Refer to the six phases of a risk assessment below. Note that this process should be dynamic in nature and the audit plans should be refreshed at least quarterly.

To augment a qualitative risk assessment process, advanced techniques such as risk-sensing tools utilizing data-driven analysis enable internal audit functions to uncover anomalies and trends. Leveraging this approach can help diversify the audit plan to a spectrum of audit activities including more precise audits (data-driven scoping), issue-based reviews, health checks, behavioral reviews and audit insight workshops. These diverse targeted activities of the audit spectrum bring enhanced value with:

- Expanded risk coverage
- Lower cost of audits
- Higher ROI on audit investments
- Business relevant findings
- IA reliance model on second line and some first line activities

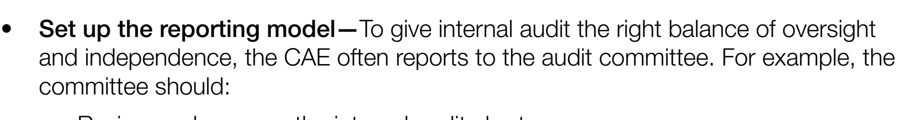


- **Add information systems (IS) auditing—**In today's digital age, as companies evaluate their internal accounting controls, they also need to look at their information systems and cyber posture and make sure the data they process is reliable. A great way to do this is to add IS auditing as a function in the internal audit department. Companies can choose to dedicate a separate IS audit group, add it to the general audit function or outsource it through staff augmentation or co-sourcing. Each approach has its pros and cons. And the success of any approach depends on what senior management expects from the IS audit function. Management should also include the goals and expectations of this function in the charter for the internal audit department.
- **Consider other regulatory compliance risks—**As internal audit develops their audit plan, they should also consider compliance-related topics like cybersecurity and privacy, the Foreign Corrupt Practices Act (FCPA) and conflict minerals disclosures. These issues have become more common and are getting attention from audit committees and external stakeholders. Internal auditors should adequately assess SpinCo's risks within its industry and account for as much risk as possible. Where necessary, internal audit should coordinate with other functional areas, such as legal, to address identified risks.
- **Set a budget—**SpinCo should set a budget for internal audit that allows enough resources to deliver the risk-based audit plan. SpinCo also needs to stay flexible to respond to changing business needs. Here are some tips for setting a budget:
  - Match it with the company's strategic plan.
  - Base it on the results of the risk assessment and audit plan.
  - Factor in consulting spend, technology investments and future hires.
  - Benchmark against standards for similar internal audit organizations in the industry, which can come from the Institute of Internal Auditors (IIA) or other third parties.
  - Estimate needs for the next three to five years.
- **Develop or acquire—**When companies first set up an internal audit function, they can sometimes spend too much time developing and investing in new infrastructure. But you should only let business goals and your risk profile drive this investment. Before deciding to invest in auditing infrastructure, you should review:
  - Risk assessment methodologies
  - Audit-planning protocols, documentation and review processes
  - Where to find and how to integrate best practices
  - Plans to execute internal audit projects
  - Quality control processes
  - Processes to track, resolve and communicate audit findings
  - Human resource management and administration

  You can use internal audit software to make your audit process more efficient, accurate and consistent. You can also use data analysis software to enhance the audit. This offers computerized testing of entire populations of data (instead of relying on detail testing of sample data).

  When it comes to audit tools and processes, you can either develop your own or get them from a third party. As an example, we offer our Enterprise Insights Technology (EIT) tool, a continuous monitoring and analytics platform. It gives you a single place to improve your business process risks, controls and compliance, plus maintain audit documentation.

  No matter which solution you choose, your infrastructure should include a quality assurance process. This makes sure SpinCo is following its own auditing practices plus the IIA's Standards for the Professional Practice of Internal Auditing.
- **Coordinate with external auditors—**The internal audit team should collaborate with external auditors. How these two groups interact depends on the charter for the department, plus any guidance from the audit committee and chief audit executive (CAE) through the yearly audit plan process. The point of this coordination is not to get approval but to make sure external auditors know the role of internal audit and the internal audit plan.



- **Set up the reporting model—**To give internal audit the right balance of oversight and independence, the CAE often reports to the audit committee. For example, the committee should:
  - Review and approve the internal audit charter
  - Review and approve the risk-based internal audit plan
  - Make sure the team has the right scope and resources to do an effective internal audit
  - Get frequent communications from the CAE about how internal audit is performing against the audit plan
  - Review and approve the CAE's yearly performance and compensation

In most organizations, the CAE reports to the audit committee directly, which helps keep the function more independent. This person also reports administratively to an organizational executive, typically the CFO or CEO. Each year, the audit committee should review the CAE's performance. Also, SpinCo should keep the CAE's compensation separate from organizational performance, which helps keep the function more independent.

Sarbanes–Oxley Act considerations

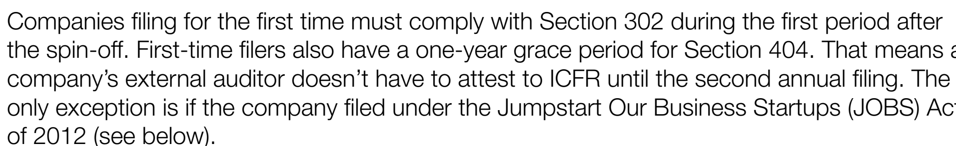
SpinCo should pay special attention to the Sarbanes–Oxley Act (SOX), which sets new guidelines for corporate responsibility, accountability, transparency and behavior. It also includes control requirements for spin-offs now that they're a stand-alone company (see the certification rules under Section 302 and Section 404). The scope of these requirements for SpinCo as part of the overall Parent organization may have been limited or non-existent. Therefore, the effort to comply with these requirements may be substantial and should be planned for in advance.

In response to Section 302 of SOX, the SEC prescribes that company leaders have to make regular certifications. The CEO and CFO (or equivalent) should certify that they're responsible to set up and maintain disclosure controls and procedures, which include internal accounting controls over financial reporting. Each year and quarter, the CEO and CFO should file a Section 302 certification, which says that their disclosure controls and procedures are operating effectively. In all cases, the CEO and CFO must send a 302 certification with the SEC filing. This certifies that:

- The signing officers have reviewed the report.
- The report is accurate and complete (it couldn't be considered misleading, with any untrue statements or material omissions).
- The financial statements and related information fairly present the financial condition and the results in all material respects.
- The signing officers have set up internal controls, have evaluated these internal controls in the past 90 days and have reported on their findings.
- The report lists all deficiencies in the internal controls and details about any fraud that involves employees who work on internal activities.
- The report shares any significant changes the company has made in internal controls or other factors that could have a negative impact on the internal controls.

Section 404 of the Sarbanes-Oxley Act says issuers must find out how effective their internal controls over financial reporting are. Typically, internal audit plays a role in determining management's effectiveness of internal controls. It also prescribes that companies hire an independent auditor to review and report on management's assessment of its internal controls over financial reporting (ICFR).

Disclosure controls and procedures (DC&P) is a new term that covers financial and non-financial information. It includes efforts to make sure the company collects and passes on to management any information to be disclosed so management can decide a course of action. The financial information must be more accurate and complete than GAAP requires. The rules also call for real-time disclosure and require management to tell the audit committee and external auditor every quarter about all material internal control breakdowns. They must also report any fraud involving management or other employees with a significant role in internal controls.

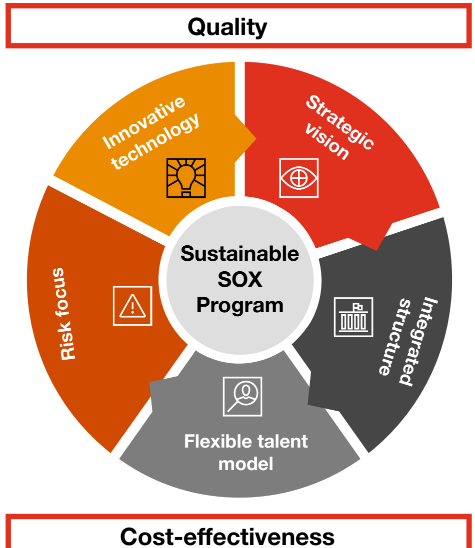


Companies filing for the first time must comply with Section 302 during the first period after the spin-off. First-time filers also have a one-year grace period for Section 404. That means a company's external auditor doesn't have to attest to ICFR until the second annual filing. The only exception is if the company filed under the Jumpstart Our Business Startups (JOBS) Act of 2012 (see below).

Any ICFR report must include:

- Management's role in establishing and maintaining adequate internal control over financial reporting
- Management's assessment of how effective these controls are
- The framework used to evaluate effectiveness (e.g., COSO 2013 framework)
- A sign-off from an external auditor (Section 404)

Normally the company's external auditors sign off on internal controls over financial reporting. But the JOBS Act helps smaller companies going public by allowing some exemptions from SOX. For example, for the first five years after a spin-off, companies that qualify as an EGC don't have to file any Section 404(b) forms. These companies are exempt from the Section 404(b) requirement but not all other SOX provisions. Management must still certify that internal controls are operating effectively. And that means documenting and testing the controls.



Clear vison
A clear vision and SOX strategy focuses on sustainability of a quality-driven, cost effective program over the long-term

Integrated structure
A formal structure integrates multiple stakeholders together to execute SOX strategy effectively, and where applicable, other compliance activities

Flexible talent model
The talent model balances the expertise and fluctuating resource demands (e.g, peaks and valleys) required to deliver quality at the lowest cost of compliance

Risk focus
A top-down focus on risks of material financial statement misstatement throughout the SOX lifecycle enables a right sized scope and approach

Innovative technology
Technology and Innovation is used as an enabler of SOX compliance activities, drives efficiency, provides greater insight and lowers the total cost of compliance

To effectively plan for the spin-off, careful consideration should be given to specific areas of Sarbanes-Oxley to ensure timely compliance, where relevant to the following.

- **Understand what the rules call for—**You must review internal controls over financial reporting and disclosure every quarter under Section 302 of SOX and annually under Section 404 of SOX. Management must identify what needs to be disclosed and document the processes and controls that support their disclosure practices. You'll need to do this, even for information you find doesn't need to be released. It's vital that SpinCo starts documenting its processes and controls well ahead of time to comply with SOX. We usually recommend companies plan on taking nine to 12 months before they'll be ready to satisfy all SOX requirements.
  - DC&P, which is broader than traditional internal controls over financial reporting, includes without limitation controls and procedures designed to ensure that information required to be disclosed is accumulated and communicated to management to allow timely decisions regarding those disclosures. Internal accounting controls over financial reporting are a subset of disclosure controls and procedures.
  - Although companies don't have to certify 8-Ks and 6-Ks or proxy/information statements, they must have a way to include that information in disclosure controls and procedures. This means you'll need a way to identify items of interest to the public that you may have to disclose under the SEC's rules.
  - Management must also set up ways to understand their business's risks and which risks they may need to disclose on a real time basis. They also have to find out how effective these policies have been within 90 days after the end of the fiscal year and each quarter.

- **Assess current processes and controls—**The Parent must look at its financial reporting function and identify any concerns. Consider business process controls, IT general controls and entity-level controls. The first step is to gather information and documentation, which means having to:
  - Walk through the design and documentation of internal controls covering financial reporting and key reports used to operate the control.
  - Perform testing on the operating effectiveness of internal controls to identify any gaps, weaknesses or areas of concern.
  - Identify and inventory required disclosures:
    - Get management's summary of disclosure obligations.
    - Use checklists to identify possible disclosures.
    - Look at the current business and determine the disclosure obligations.
    - Look at financial and non-financial items. Non-financial items could include:
      - Competition
      - Regulatory environment
      - Business goals and strategy
      - Governance issues
      - Intangibles
      - Brand matters
      - Reputation
    - You should also look at:
      - Peer disclosures
      - Reports from outside analysts about the company
      - Peers and industry
      - Current areas of SEC enforcement
      - Past SEC comment letters
  - Review current SEC filings (10-K, 10-Q, 8-Ks) as well as recent press releases, forecasts and analyst calls to see what SpinCo or the Parent are currently disclosing
  - Define current DC&P.

    Companies must list their internal controls and disclose any concerns or weaknesses. This includes a review of past internal audits and management's reactions, external auditor findings and reactions and a look at what management thinks are current issues.
- **Identify gaps—**SpinCo must find any gaps in its controls and fix them. It's a vital part of the process to manage risk and certify disclosure controls and procedures before the initial filing. This should include a review of internal controls across financial reporting, operations and compliance. You should also check how effective your existing disclosure controls and procedures are, including controls over financial reporting operations and compliance. Map disclosures in draft SEC filings to their legal obligation. And map all required disclosures to existing disclosure controls and procedures, including controls over financial reporting, operations and compliance. This way, you can identify specific gaps and recommend which to address first in your action plan. Typical issues and risks that are common in this space that may result in gaps to the overall company may include the following:
  - Changes to the system or migration of data resulting in higher risk of data integrity issues
  - Pressure to achieve successful separation of companies resulting in lack of attention towards documented internal controls over financial reporting including proper segregation of duties

As you move closer towards your spin-off date, the following items should be contemplated:

- **A plan for remediating gaps—**SpinCo will need to assess gaps periodically, typically prior to the quarterly certification, to understand if additional action items are required. That means looking at disclosure requirements, current controls and identifying any gaps and resolving them. The information from the gap analysis will help you write and put into action a plan to fix any problems. This process will include looking at the design and effectiveness of controls over financial reporting.
- **Evaluation of internal control operation—**Before SpinCo can properly prepare the annual Section 404 certification, you'll have to find out how well its controls and procedures are working. Then you'll have to define where you can improve and decide which projects are most important so you can meet management's goals. Finally, you'll need to write a plan to include in the filing.

Post spin-off, SpinCo will need to formalize its process as follows:

- **A formal process—**Before SOX, most companies didn't have a formal way to consistently apply principles and procedures. And they had no way of knowing if they had the timely and accurate information they needed for disclosure and reporting decisions. SpinCo will need to create this process and it should become part of its culture and structure. Think about issues like:
  - Oversight and accountability
  - Company-wide policies and procedures to guide governance and disclosure and the day-to-day policies that support them
  - Audit, or other ways to check activity on a regular basis
  - Ways to monitor day-to-day controls and processes to help management keep an eye on key performance indicators
  - Plans to communicate the importance of disclosure controls as well as ways to update policies and changes in business
  - Training programs so employees know what the expectations and policies are
  - Ways to measure the effectiveness of SpinCo's principles and procedures

A formal process should help management decide how effective the controls needed under SOX are. You'll likely use some elements of auditing and monitoring. You can do this in-house with the proper processes in place and with the right level of resources. But you may also find you need regular outside help. You'll also find a wide range of help—like governance, risk and compliance (GRC) tools—that will make it easier to monitor and test internal controls by automating collecting, testing and analyzing data. Tools like this can also cut the costs of SOX compliance.

For more information on internal controls over financial reporting related to your spin-off or SOX and internal audit matters, please contact:

Monica Nayar

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Treasury

You'll have to make decisions about treasury and risk management. The basics will include things like separate banking relationships, cash management processes and financial risk management structures.

But to make sure the spin-off is smooth and risk free, you'll also have to look at treasury and cash-management risks and analyze the possible costs and benefits of each. And you'll need to focus on other workstreams that rely on treasury such as HR, tax, accounting and legal. Your team will need to keep the overall spin-off goals in mind through the whole process.

In this section we cover:

Due diligence and planning

Understand what treasury's requirements will be. Minimize risks ahead of time so SpinCo can get down to business on Day One.

Managing cash, liquidity, debt and treasury systems

Make sure you're aware of all the issues you need to consider when choosing the best strategy for managing cash and debt and how to set up the right treasury system.

Due diligence and planning

To effectively plan for the spin-off, it's important to do your due diligence and know the company's treasury requirements. To do this effectively, consider the following.

- **Due diligence on treasury's requirements and risks that relate to the deal—**You need to plan for and mitigate any operational issues that could prevent the business from operating on Day One. To do that, you need to understand the current state of treasury's operations. That includes the:
  - Organizational structure
  - Foreign exchange (FX), interest rate, commodity and credit exposure profile
  - Cash management, cash flow and working capital profile
  - Banking structure
  - Funding and liquidity structure
  - Trade finance instruments
  - IT systems
  - External debt instruments, including any covenants
- **Developing a spin-off plan for treasury—**To organize itself and plan for the spin-off, treasury should develop a detailed transition. The plan should break down high-level initiatives into specific steps, each with dependencies, assigned resources and timing. Prioritize them so that you focus on the most critical milestones, like having enough funding and liquidity, taking care of payroll and being able to manage collections and disbursements. When developing this plan, you should think about how much separation you need on Day One.
- **Working out what you need for the transition—**SpinCo could think about using the services of the Parent's treasury department for a while after the spin-off. Both the Parent and SpinCo might want some treasury functions—like cash collections and disbursements—to be separate on Day One. But you should look for other treasury functions where transition service arrangements might be appropriate.

  As you move further into the process and start doing the spin-off, the organizational structure and strategies of the treasury department should be formalized.
- **An organizational structure for the stand-alone treasury—**To build an effective treasury department, you need to clearly define its role in the organization. And the treasury department's strategies need to be consistent with SpinCo's overall corporate objectives. You also need to consider:
  - Properly trained and experienced staff
  - Communication between treasury and other departments
  - Developing policies for communicating the treasury staff's roles and responsibilities
- **Hedging and derivatives strategies—**You'll need to consider looking at the current hedging strategy again to decide on any potential changes in light of SpinCo's objectives and its exposure profile after the spin-off. The key to minimizing exposure is to spot significant financial risks and establish processes to manage them. Treasury should also work closely with the accounting teams to support and evaluate any adjustments to hedge accounting as a result of the spin-off.

Managing cash, liquidity, debt and treasury systems

During the planning process, special attention should be paid to cash management processes, the liquidity structure and other areas of risk management as follows.

- **A cash management structure—**To avoid disruptions to business operations on Day One, you'll need to focus on understanding the sources and uses of cash and on developing a robust process for managing it. Best practices include:
  - Having a cash forecasting process to make sure there's transparency about funding and liquidity needs on Day One, and about ongoing cash positioning
  - Having a process to extract excess cash beyond Day One needs out of SpinCo
  - Optimizing the way you use excess cash by using various cash-management tools. These include lock-box accounts, zero-balance or sweep accounts, overnight investment vehicles and other banking arrangements
  - Working with tax and legal to understand where you can get funding and liquidity effectively using intercompany loans
- **Banking, funding and liquidity structure—**SpinCo's management—possibly with the Parent's help—should decide on the financial institutions that it will use for its banking services and future financing arrangements. Once you've decided, you need to understand the desired banking, funding and liquidity structure and start putting it into practice by opening new bank accounts, transitioning existing bank accounts and finalizing financing arrangements. To make sure you get the best possible terms on any financing arrangements, SpinCo may want to start establishing relationships with credit-rating agencies early on in the spin-off process.
- **Trade finance facilities—**You need to understand the Parent's current guarantees, bank guarantees, surety bonds, letters of credit, etc. Then you'll need to work with banks to calculate the cost of transitioning. After that, start working with legal to transition the facilities.
- **Restrictive covenants—**You need to take care, when drafting loan documents and indentures, to protect SpinCo from restrictive covenants—financial and otherwise. Typical restrictive covenants can include restrictions on dividend payments and limitations on capital expenditure and financing flexibility. You should also work with legal to review the current external debt instruments and develop a compliance process for covenants, to manage and monitor debt compliance. That will make sure you comply with any financial covenants, change of control clauses and other obligations.
- **Decisions about your risk-management needs—**SpinCo's risk-management program is often coordinated with the Parent, and it may include some risks that are self-insured, like workers' compensation, auto and general liability. You should make sure that SpinCo has a stand-alone risk-management program on the date of spin-off. The stand-alone strategy should include:
  - Identifying significant insurable risks
  - Deciding on the right insurance methodology—whether that's self-insurance, deductible limits, policy limits or something else
  - Negotiating insurance policies—you should explore transition service arrangements with the Parent to keep overall insurance costs down
  - Establishing who's responsible for obligations before the spin-off, especially for self-insured liabilities

Additional considerations come into play as related to SpinCo's go-forward debt strategy, implementing and maintaining critical treasury systems, optimizing working capital and other areas as follows.

- **An overall debt strategy—**SpinCo's initial level of indebtedness is already established by the spin-off. But SpinCo will still need to develop an overall debt strategy to finance its need for working capital and its plans for adding or expanding capital. It will have access to private and public debt markets, with public markets involving registering with the SEC and trading openly on national exchanges. Choose the mixture that's best for SpinCo's objectives.
- **A strategy for excess cash flow—**You should decide the best available use for excess cash, if there is any. Some possibilities are listed below.
  - **Buying back stock—**After the spin-off, depending on the market's reaction to SpinCo's share price, it might be beneficial to use any excess cash flow to buy back shares on the open market. This is often an inexpensive way to increase earnings per share and it gives the market a strong signal of management's confidence in the company.
  - **Making strategic investments—**You could keep excess cash flow to pay for strategic acquisitions or expansion after the spin-off.
  - **Reducing debt—**You could use excess cash flow to cut SpinCo's debt. Reducing SpinCo's leverage could give it stronger credit ratings, enabling it to get better rates on future financing.
- **Migrated or new treasury systems—**SpinCo's treasury systems will usually be covered by the TSA. That allows the new treasury function to decide what it needs from its systems after the spin-off, so it can develop a detailed transition plan for its technology. After the spin-off, SpinCo should focus on the transition to its future-state treasury management system (TMS) and other supporting technology.
- **Optimized working capital management—**You should focus on optimizing key working capital levers. That includes cutting down on inventory, speeding up the collection of receivables and lengthening the duration of payables. By developing key performance indicators and giving the whole company an emphasis on working-capital management, you can significantly improve cash flow, funding and liquidity.
- **A management reporting framework—**Develop a management reporting framework and performance metrics to increase the transparency of treasury's activities, performance and risk. In the end, doing that will improve SpinCo's compliance with existing policies and minimize its operational risk.

Tax

Given compliance complexities and the potential for lost value, it's important to think ahead regarding the structure of the tax function and potential for tax-specific TSAs.

In this section, we will cover:

Tax department organization and tax sharing agreements

Determining the tax departmental structure and approach and coming to an agreement on transition issues are key to spin-off planning and execution.

Tax department organization and tax sharing agreements

During the planning process it's critical to think through the following to ensure you are appropriately prepared:

- **Tax departmental structure and approach—**Management should develop the tax department structure and roles to fulfill overall tax objectives. The key strategic decision to be made is whether the company's tax department will contain all necessary resources internally or whether certain tax functions will be outsourced to third-party providers. In determining the best structure for the company, the following options should be considered.
  - Full-scope tax department—In adopting a structure similar to the Parent, some spun off companies have duplicated a full scope tax department where all tax planning and compliance functions are handled by an internal tax department. These functions include tax planning, tax provisions, special projects, federal and state audit management, federal and state tax return preparation, sales and use tax matters, property tax matters, payroll tax and information reporting activities. Outside firms may also be used as consultants for special projects or technical assistance.

If the decision is made to operate a full-scope tax department, particular attention should be given to automating the tax compliance function to enhance its efficiency and effectiveness.

The tax department should take an active role in identifying information needs to enhance efficiency and avoid system changes in the future to support the tax function. In this regard, SpinCo's information needs, as a separate company, may be different from the parent's information needs.

SpinCo's tax department should identify software which can integrate the company's financial information and ultimately produce tax returns. Various software packages exist to help accomplish this goal. In addition, the current historical information contained within the parent's tax compliance system can be transferred electronically to the company's stand-alone system

- **Partial-scope tax department—**Some companies establish partial scope tax departments where a portion of the tax department responsibilities are provided by external firms for either tax compliance or tax consulting services. Companies adopt this model to manage costs necessary to maintain a fully staffed tax department.
- **Full outsourcing—**Some companies choose to outsource the entire tax function since the tax function is not a core competency. If a full tax department outsourcing is adopted, the company should still consider hiring at least a tax director before the spin-off. Having this member of management in place during the spin-off process can help facilitate a smooth transition of the tax responsibilities from the Parent.

In executing the spin-off, the following are key areas of consideration that should be carefully thought through:

- **Agreement on transition issues—**SpinCo should consider entering into a tax transition service agreement to assign responsibilities for tax compliance during transition periods as well as to facilitate a smooth transition of the tax functions from the Parent. These agreements typically include specific types of responsibilities and related performance criteria and expectations. This may include agreements relating to:
  - Preparation of SpinCo's tax information for inclusion in the Parent's federal and state consolidated or unitary returns through spin-off
  - Preparation of SpinCo's stand-alone tax returns, if any, through spin-off (e.g., separate company state income, franchise, sales/use, property tax, etc.)
  - Management of audits for pre-spin periods, including responding to taxing authority inquiries (e.g., assessments, notices, underpayment penalties, etc.) and any related research of issues
  - Establishing responsibility for reporting federal Revenue Agent Report (RAR) changes to state and local jurisdictions for pre-spin periods
  - Negotiating which company is responsible for payment of professional fees from third-party providers for pre-spin work
  - Establishing responsibility for reviewing applicable transfer tax filing requirements, liabilities, planning opportunities, etc., as a result of spin-off
  - Determining application of estimated payments, overpayments, refunds and tax credit carry-forwards from pre-spin to post-spin periods
  - Establishing responsibility for filing year-end payroll and information reporting returns for pre-spin and post-spin activities
  - Establishing responsibility for applicable international tax filing requirements for pre-spin periods (e.g., Form 5471 reporting), post-spin periods and applicable reporting requirements due to spin-off
  - Agreeing on record retention policies for historical company tax information (which will be influenced by the Parent's current record retention agreement with the IRS)
  - Agreeing on the necessary historical tax information which will be made available to SpinCo by the Parent subsequent to spin-off
  - Agreeing on tax compliance responsibilities for straddle period returns relating to sales and use tax, property tax and other non-income taxes
  - Maintenance of tax depreciation by the Parent until SpinCo is ready to convert to its own information systems
  - While ultimate responsibility for these activities will likely be outside of the tax department, the following items need to be addressed:
    - Tax gross-up calculations for relocating employees, if any
    - Filing of benefit plan returns (e.g., Forms 5500)
    - Federal excise tax filings

Information technology

IT tends to be the proverbial long pole in the tent and is one of the primary drivers of complexity in a separation. For instance, factors below directly impact separation complexity and timelines:

- Most upstream dependencies (e.g., legal entity, company code, organization design and selection) are enabled by IT.
- Commingled technology landscape adds to separation complexity and timeline.
- Multiple systems and user acceptance testing cycles
- Commingled contracts separation and vendor consent needed for TSA and Day One
- For tax-free spin-off, IT to be ready about three months before Day One

As a result, it is critical to develop a robust IT separation strategy that covers critical IT areas, identifies long-lead time activities and considers cross-functional dependencies.

IT separation strategy

Successfully separating SpinCo's IT functions from the Parent starts with a well-developed IT plan. IT must address both Day One as well as Day Two (TSA exit) considerations such as:

Day One considerations:

- Financial reporting, consolidation and deconsolidation
- Operational reporting
- Payroll and benefits, especially as benefits cannot usually port over to SpinCo without carriers mirroring the plans
- Day One collaboration suite impacts such as email, calendar, SharePoint

Day Two considerations:

- Separation of applications
- Set-up of new infrastructure
- Stand up of new IT operating model including transfer of resources
- Security design and provisioning/deprovisioning access

IT separation strategy typically has three options:

	Option one—Physical Separation	Option two—Logical Separation	Option three—Migrate to Target-State
Description	• A physical separation requires that the application and associated data is cloned/rebuilt on SpinCo dedicated hardware (server, storage), network, etc.	• A logical separation is for application to be used by RemainCo and Spinco users for a period of time; however, access controls to data will be in place to prevent SpinCo access of RemainCo data and vice versa post-close	• Implement new solution that fits future business needs. Extract and cleanse historical data as needed from RemainCo. Cover legacy application under TSA for period of time
Pros	• Allows SpinCo to configure/change application that aligns to future business strategy • Reduce reliance on RemainCo • Reduced effort compared to option 3 • Lower stranded costs than option 2	• Reduced implementation risk and timeline—typically suitable for applications requiring data segregation on Day One • Data mapping/cleansing exercise can be leveraged for future implementations	• Modernized systems • New solution that aligns to future business needs and addresses past challenges • Likely explore Software-as-a-Service (SaaS) to leverage pre-built functionality and move support/maintenance to 3rd party
Cons	• More time consuming, especially if there is aggressive Day One timeline • Requires support of system sooner (higher one time separation cost • May require significant data cleansing effort	• High stranded cost • Likely requires a future physical separation for TSA exit • Typically limited flexibility to configure/change application during TSA • Creates duplicate work	• Likely most expensive one-time costs • High stranded costs • Depending on solution, could be more time-consuming • Change management needed for adoption and training

The IT separation strategy will be influenced by a number of factors including, but not limited to the following:

- The degree of systems entanglement between RemainCo and SpinCo
- The timeline to execute the spin
- The degree of desired transformation for RemainCo and SpinCo
- Budget and resource constraints

Beyond the separation strategy, more tactical functional separation elements must be planned and executed to affect the spin-off. Six areas of focus include:

- Application separation
- Infrastructure separation
- Cybersecurity separation and risk mitigation
- Data separation and migration
- Contract separation
- Transition services agreements (TSAs)

Functional considerations for IT separation

There are six functional considerations related to IT separation and we will discuss these in detail in the subsequent sections:

Application separation

- Define high level application separation strategy
- Assess application landscape and conduct blueprinting to identify application disposition
- Develop and manage application separation plans
- Manage cross-functional and intra-functional dependencies

Infrastructure separation

- Define high-level application Infrastructure separation strategy and conduct blueprinting
- Develop and execute infrastructure separation projects for network, data center, end user computing, etc.
- Build interfaces between legacy systems for data extraction and sharing

Transition Service Agreement (TSA) Management

- Identify scope of services requiring TSAs across critical functions and processes
- Draft TSAs and reverse TSAs as needed
- Develop robust TSA management and TSA exit processes

Cyber security separation & risk mitigation

- Design approach to managing security, controls and regulatory compliance during transition
- Define system security requirements, including information access, firewall security, and internal control development for financial functions
- Secure information access through data environment separation, firewall security, IDS/password, etc.

Contract separation

- Setup Contracts separation office to assess contracts and identify critical and transactional contracts
- Evaluate critical vendors to Secure Day One rights and minimize stranded costs
- Negotiate and notify vendors of any changes in contractual terms

Data separation and mitigation

- Conduct process and application analysis to determine data separation requirements, including structured and unstructured data
- Define data migration strategy and identify and set up tools to extract, transform, and load (ETL)
- Execute and monitor data migration activities

Application separation

Application separation involves documenting current state IT landscape, application dispositioning and blueprinting.

Key activities for application separation include:

1. Define separation strategy
2. Baseline application landscape
3. Disposition applications
4. Blueprinting
5. Setup project plans and execute

Separation strategy

- Majority of the existing applications to be separated **"as-is"** to accommodate the accelerated timeline either through **logical or physical separation.**
- Enhancing the future state of application landscape is considered a post Day One activity

Baseline application landscape

- **Collect application inventory**
  - Access application repository
  - Leverage pre-deal analysis
- **Create apps profile**
  - Collect key information on description, ownership, criticality, complexity
- **Categorize based on deal governance structure**

Application dispositioning

- Work closely with **Business and IT owners to determine disposition for each application** based on their usage by parent and divested BU
- Dedicated applications are typically dispositioned as into "Retain" or "Give and Go"
- Shared applications are typically dispositioned as "Extract and Retain", "Configure in Place", "Clone", "New Build"

Application blueprinting

- Document business process by function in blueprinting templates
- **Map business process** to applications
- Conduct blueprint **interlock sessions-** joint discussions between business units and IT to review and understand how application disposition affect business process

Setup project pans and execution

- Setup **project execution template and tracking** to measure execution process and alert the IT and business unit teams of upcoming risks and issues.
- Follow **SDLC or Agile model** of design, build, test-SIT/UAT and cut over

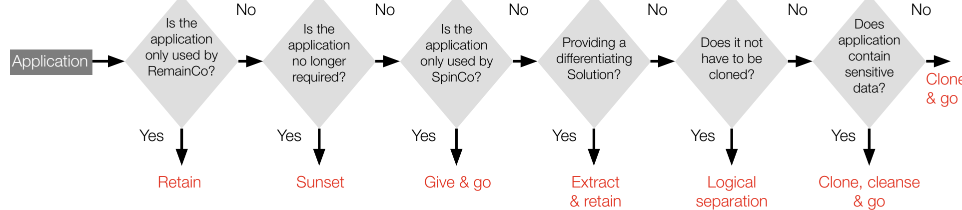
Standard SDLC cycle

1. **Define separation strategy:** Application separation strategy needs to be defined in line with the overall IT separation strategy. Typically, applications are logically separated or cloned for Day One. Any transformation or enhancements are usually past the Day Two scope. In some cases, applications may be transformed for Day One based on criticality, age, etc. Applications such as ERP, CRM etc. will have specialized separation strategies given the nature and complexity of these applications.
2. **Baseline application landscape:** Once application separation strategy is defined, a baseline application landscape needs to be defined based on a review of pre-existing documentation on IT assets, organization charts and data gathering exercises. Application baseline typically consists of a list of applications with owners and organizational mapping, capability supported, usage across business units (especially the divested business units), type of application, etc.
3. **Disposition applications:** Applications are then dispositioned based on their usage by Parent and divested business units. See below framework for determining application dispositions.

Application disposition process

Increasing competency of disentanglement

#	Disposition type	Description	Criteria
1	**Retain**	Retain application as-is with no changes	• Application and underlying data are needed by RemainCo, but no longer needed by any of the spin-off business units (BUs)
2	**Sunset**	Remove application from the landscape	• Application is no longer needed
3	**Give & Go**	Data required is extracted and application moved as-is from current location to target data center	• Dedicated application used by only one of the spin-off BUs with no commingling • Need to be moved to the identified target infrastructure/data center
4	**Extract & retain**	Extract required data and retain the application at the current RemainCo location	• Application is no longer needed by any of the spin-off BUs; however spin-off BUs require access to the underlying data
5	**Logical separation**	Logical separation by configuration without physical separation	• High complexity shared application that cannot be split into separate instances by Day One • Logical separation and configuration data update for differentiated access (Legal entity changes) • Application to be provided as a service to spin-off BUs until the TSA period
6	**Clone & Go**	Clone complete application and underlying data	• Shared application that is needed by two or more spin-off BUs and/or RemainCo; No Data sensitivity/compliance risks
7	**Clone, cleanse & go**	Clone complete application and cleanse data that should not be transferred	• Shared application; all data to be transferred to other entity's data center • Sensitive data which needs to be cleansed for each instance



As discussed earlier, complex and critical applications will have additional nuances in the disposition exercise. Below is a sample set of disposition options for an ERP application:

	Option one—Physical separation (Clone & Cleanse)	Option two—Logical separation with TSAs	Option three—Hybrid solution
Description	• Create a separate physical environment for the Divested Entity on Day One • Create "Gold" instances to hold baseline configurations • Convert configurations and RICEF (Reports, Interfaces, Conversions, Enhancement Forms) relevant to SpinCo	• Continue to operate SpinCo in the RemainCo ERP system as-is using current applications • Ensure SpinCo personnel cannot post transactions to RemainCo Business by implementing a "Glass Wall" • Cut over ERP to target state system of SpinCo	• SpinCo continues to operate as-is using current applications on Day One • Ensure SpinCo personnel cannot post transactions to RemainCo Business by implementing a "Glass Wall" • Setup SOX Complaint financial reporting enabled by Data Warehouse table top solution • Cut over ERP and connected applications to SpinCo's systems when ready
Pros	• No TSAs required to support ERP post Day One • SpinCo operationally independent of RemainCo and can begin synergy realizations on their schedule • Frees up RemainCo IT to work on RemainCo priorities • Minimizes stranded costs as licenses and people supporting the applications can be transferred to SpinCo • Lowest stranded cost	• Lowest effort but significant risk versus physical separation • Avoids a two-step journey to SpinCo target-state systems • Minimal changes for SpinCo employees and IT support staff	• Achieves physical separation of Engineering & Non-ERP connected business application by Day One • Reduces number of TSAs required & their duration • Table-top solution reduces risk to potential delays of cloning ERP + Ecosystems by Day One or earlier deal close • RemainCo in control of physical separation schedule and transferring stranded costs
Cons	• Highest IT efforts required to complete cloning of ERP and all connected applications by Day One. Risk of satellite systems not being ready • Potential for disruption to SpinCo business operations if all Day One required satellite apps are not ready	• Higher stranded costs • Comprehensive TSAs required and exit timelines driven by SpinCo (12+ months) • RemainCo changes/enhancements may require parallel/divergent codebase • Significant effort required for Logical separation • Risk of commingled data over the longer TSA period • May expose data/process/systems related to intellectual properly of RemainCo • Significant stranded license and people costs	• Risk of commingled data in ERP + Ecosystems during short TSA period (until clone goes live) • Cash settlement processes using table top solution cannot be run long term (1-6 month solution)

4. **Blueprinting:** Once Day One dispositions for applications are identified, a blueprinting exercise or workshop is conducted to review and understand implications on business processes. These sessions include business and IT representation and are used to develop the overall Day One IT and business blueprint. Application dispositions may be adjusted based on session findings and outcomes.
5. **Setup project plans and execute:** Post finalization of application dispositions, application/workstream owners develop a detailed execution plan to get to Day One. While project plans for multiple applications may be combined for ease of managing, it is recommended that each application have its dedicated project plan. This will enable better transparency and visibility into execution progress, dependencies and roadblocks, if any.

Infrastructure separation

IT infrastructure is often considered a complex, time-consuming and expensive component of a divestiture. All IT functions—including processes, applications, information security and end-user operations—are heavily dependent on infrastructure components. A pre-emptive planning for IT infrastructure separation is paramount to the success of the divestiture as well as the future IT infrastructure design of the divested entity.

It is noteworthy that IT infrastructure separation costs are significant components of total separation costs. This cost depends on the scope, scale and complexity of separation. Key phases for infrastructure separation include:

1. **Strategy definition—**This phase involves development of IT infrastructure separation strategy and blueprint.
   a. **IT infrastructure separation strategy—**This would ascertain that the spin-off entity should be able to operate independently by Day Two. A two-way active directory (AD) trust may be put in place between two companies to fully stand up the spin-off entity's stand-alone IT infrastructure. Further, infrastructure separation goals for Day One vs. Day Two will need to be defined which may depend on various factors including business requirements, external factors (legal and regulatory) and impact to end user.
   b. **IT Infrastructure blueprint development—**IT blueprint outlines the full scope of IT infrastructure service required by SpinCo. Each service must be analyzed to determine whether it can be separated by Day One or whether TSA will be required.
2. **Separation planning—**This phase involves separation project formulation and developing separation solution.
   a. **Separation project formulation:** Goal of separation planning is to identify and formulate IT infrastructure separation projects required to successfully separate the IT infrastructure in accordance with scope plans for Day One and Day Two. This would involve identifying and prioritizing projects based on identified scope, determining internal and external dependencies and resource allocation.
   b. **Separation solution development:** IT infrastructure separation often involves dependencies with other separation workstreams (i.e. human resources). Each of the core infrastructure components needs to be looked in detail to understand the scope and magnitude of activities required for separation. Please refer to the image below that shows scope and key considerations that will drive separation solution development.

Key services	Scope	Key activities
Data center housing	• Data center Infrastructure • Storage, databases and compute • Redundancy, capacity, rack space	• Separation of data center assets on co-located data center, on premise data center and cloud hosted environment • Separation of all DC assets namely compute, storage, SAN fabric, rack and cabling infrastructure • Separation and stand up infrastructure required for supporting the business like monitoring, backup and recovery, disaster recovery and others
Network services	• WAN • LAN • Remote access/VPN • Video conferencing	• Separation of LAN Infrastructure for the entities including services such as DNS, Time Services (NTP), and other basic infrastructure services • Separation of supporting network services such as client based VPN and access mechanisms for employees • Separation of partner connectivity, including dispositioning of all partners to the right business and termination
End user services	• End user Compute • Email/collab • End user software • Unified communication • Patching and upgrades • Authentication • Service desk	• Separation of the Identity and Access Management infrastructure (IAM) • Dispositioning and migration of end user compute devices to the go-forward domains • Separation of key services such as Skype and Email • Collaboration with the data work stream to segregate data including shared files and folders, Sharepoint and other data repositories

Several key areas such as active directory, network and email and messaging require special mention in the context of spin-off.

Active directory (AD): SpinCo must stand up its own identity management systems such as active directory. Once again, the most obvious approach may not be the most efficient. There are unique approaches such as cloning of AD that may expedite the solution significantly. A brief summary is included below:

Email and messaging

	Option one—Clone current solution	Option two—Requires new AD structure
Description	• Clone & cleanse current AD domain controller in clean space and operational cutover in conjunction with physical network separation • Similar to operating AD in disaster-recovery mode	• Traditional AD migration to SpinCo's target-state-design—office by office, app by app migration
Pros	• Fastest approach for cloning/separating AD • Least disruptive to end-user and applications as no desktop migrations or changes to application access required	• Avoid 2-step approach to target state solution • Minimizes security risks for RemainCo
Cons	• Once cut-over, there can be no native network connection between RemainCo and Clone environments • Potential security risk due to sharing of RemainCo's AD forest design	• Long lead frame time required to complete • Disruptive end-user experience and requires to new AD structure • Increases separation costs

Network and telecom: Network and telecom must be separated either physically or at least logically to limit exposure to cyber and other risks from SpinCo to RemainCo and vice versa. A few criteria for determining the best approach are included below:

Network and telecom

	Option one—Physical separation	Option two—Logical separation
Description	• Parent initiates physical separation of MPLS, ISP and Voice services by deploying new circuits at DCs/shared-office-sites and cloning voice call managers & gateways. Cut networks after majority of application separation is complete	• SpinCo initiates physical separation of MPLS/ISP network; Migration to SpinCo's target-state voice platforms
Pros	• Cleanest option for separation • Logical traffic separation is still possible while waiting for physical separation • Option to minimize stranded costs for sellers	• Avoid 2-step approach to target state telco-provider & solution stack • Less work for RemainCo—offer network services via TSAs
Cons	• Once network (and AD) are separated, access to RemainCo apps limited via VDI • Requires interim TSAs until new network circuits are in place (long lead times for international sales)	• SpinCo in control of physical separation deadline/schedule • SpinCo's network may still be susceptible to cyber security vulnerabilities resulting from the Parent's network or end-points

Email and collaboration: Email and collaboration suites must be transferred to SpinCo under their domain. While this may sound simple, it presents unique challenges around transferring history, especially if using SaaS systems such as O365 or Google Mail. In addition, cleaning up sensitive emails, especially from "red-flagged" executives, requires special attention. A few critical criteria and pros/cons are included below:

Email and messaging

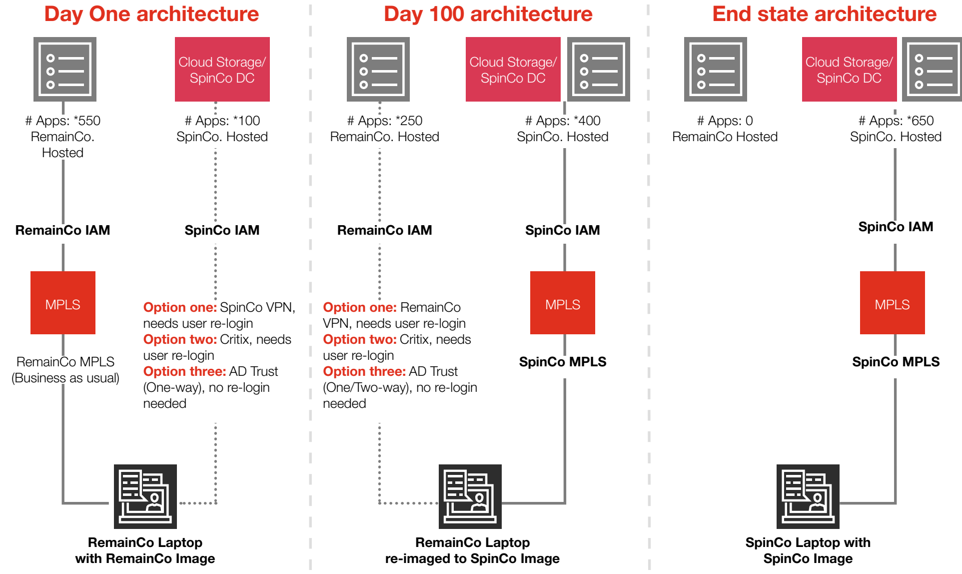
	Option one—New accounts in SpinCo system	Option two—Clone current solution
Description	• Provide a new identity to SpinCo users and provision new email/messaging accounts on Parent's on-premise/cloud platform by Day One • Migrate mailboxes from Parent's solution to SpinCo and setup mail forwarding between the two domains for limited period of time • Cleanse process mailboxes and distribution lists	• Clone Parent's on-premise solution platform in clean-space • Migrate user mailboxes and calendar history to clone by Day One • Cleanse process mailboxes and distribution lists
Pros	• Users get @SpinCo.com email accounts on Day One • Enables faster collaboration with SpinCo employees via global address book and Messaging	• Seamless user experience as minimal change involved • No TSAs required email and messaging services • Continues to meet current regulatory/security compliance requirements and corporate standards
Cons	• End user training & support required to enable support for dual mailboxes, calendars and contact migration • Dual licensing costs for temporary period of time	• Does not give @SpinCo.com email accounts to users on Day One • Difficult to enable Global Address Book capabilities • Increases stranded costs

3. **Separation execution—**Once the Day One approach is determined, the execution phase begins which involves sub phases such as requirement gathering, design and build, test and cutover activities.

Once the separation strategy is set, IT must determine the mechanism for users to access the systems. This access approach will vary before Day One, during the TSA period when users will need to access some of the RemainCo systems and other SpinCo specific systems that have already been migrated to SpinCo, and finally, they will need to access applications post TSA decommissioning.

To ensure a seamless experience for users, IT must establish a clear strategy to maintain user access during the three distinct phases. One such recommended strategy is included below:

Application access post Day One



Cybersecurity separation and risk mitigation

For a spin-off to proceed with an understanding of the cyber risks, SpinCo must incorporate the unique cyber risk considerations into its Day One/Day Two planning. Traditionally, cyber risks have taken a back seat in spin-off planning due to various reasons:

- **Cyber as an afterthought—**Cybersecurity is not often viewed as a business enabler, resulting in separation activities without proper security controls in place.
- **Inadequate skill set—**Specialized cybersecurity skill set for spin-off is not on team to identify and remediate cyber risks.
- **Dependency identification—**It is not immediately obvious to stakeholders where and how cyber should be engaged outside of IT separation.

Some of the key reasons for cyber risk considerations during a spin-off include:

- Threat actors target companies involved with transactions to gain access to either information or networks.
- Divested business units providing services required for security or other statutory, regulatory or contractual compliance require such attention.
- Transition services agreements (TSAs) provide increased and prolonged connectivity to critical information assets. Information access and limited monitoring in TSA environments increase cyber risks.
- Employees and contractors affected by the transaction pose a higher risk to sensitive information.
- Retained information assets (non-transferred, applications and infrastructure) are at increased risk of compromise during transition period.
- Production information is cloned and transferred during separation activities with inconsistent data protections.
- An inability to maintain systems and sensitive data in a secure state on shared applications and infrastructure during TSA period may exist.
- Compliance practices are not aligned with new company policy.
- An undefined cybersecurity program for SpinCo or a high reliance on RemainCo infrastructure for monitoring and operational support could result in:
  - Ineffective protection measures for SpinCo assets
  - Excessive access to sensitive SpinCo information, systems and infrastructure

Due to the overwhelming impact of such transactions on the company's assets—including business processes, information and people—early incorporation of cyber risk management activities into the M&A lifecycle may reduce the strain of cyber risk and compliance. The Identify-Detect-Protect-Respond-Recover (IDPRR) Innovation Framework defines mitigation strategy during a separation:

As companies plan for the spin-off, the IT separation plan should include the below to effectively manage cyber risk:

- Due diligence findings related to cybersecurity
- High-level separation plans for IT security, covering overall strategy, application risk, network connectivity and activity monitoring
- Risk assessment for application access—including methodology. This should consider each application's disposition status (whether that's retained, shared or conveyed, for example).
- A high-level inventory of SpinCo's sensitive information and processes and a cybersecurity review of significant changes to IT, including separated sites and changes to network perimeters
- Compliance risk analysis—In many cases, spin-off change the application portfolio, network architecture, policies, processes and resources that have compliance obligations, including SOX, HIPAA, GDPR, China Security Law, The California Consumer Privacy Act of 2018, PCI DSS and others. Each has requirements to determine an in-scope environment, document policies and procedures to safeguard relevant data and, in many cases, log and monitor its usage.
- Prioritize the remediation or mitigation of vulnerabilities present in conveyed assets to increase their value and vulnerabilities present in shared assets to reduce risks of resources with increased access.
- A high-level operating model for TSA security. This should focus on developing key security processes, like TSA access requests, TSA environment activity monitoring and incident response.
- High-level security projects and initiatives to support SpinCo's security requirements, by building its security capabilities and improving effort, timing and resources. These security capabilities should consider the migration, design and development of target state security capabilities for SpinCo, including:
  - Security organization design—roles, responsibilities, skills, headcount
  - TSA exit—migrating or replacing security service provided by the Parent during TSA, including:
    - SIEM/SOC
    - Identity and access management
    - Segregation of duties
    - Threat and vulnerability management
    - Patch management
    - Firewall management
    - Compliance management (e.g., PCI, SOX)
    - Cybersecurity testing of new IT/technology instances within SpinCo
    - Incident response plan for SpinCo

In terms of doing a spin-off, there's no disclosure requirement specifically covering cybersecurity risk and cyber events. But because of the risks and costs of a cyber incident, the SEC strongly encourages companies to tell investors about any material cybersecurity risks and events as soon as they can.

Data separation and migration

Data separation and migration during a spin-off may be challenging owing to several reasons including:

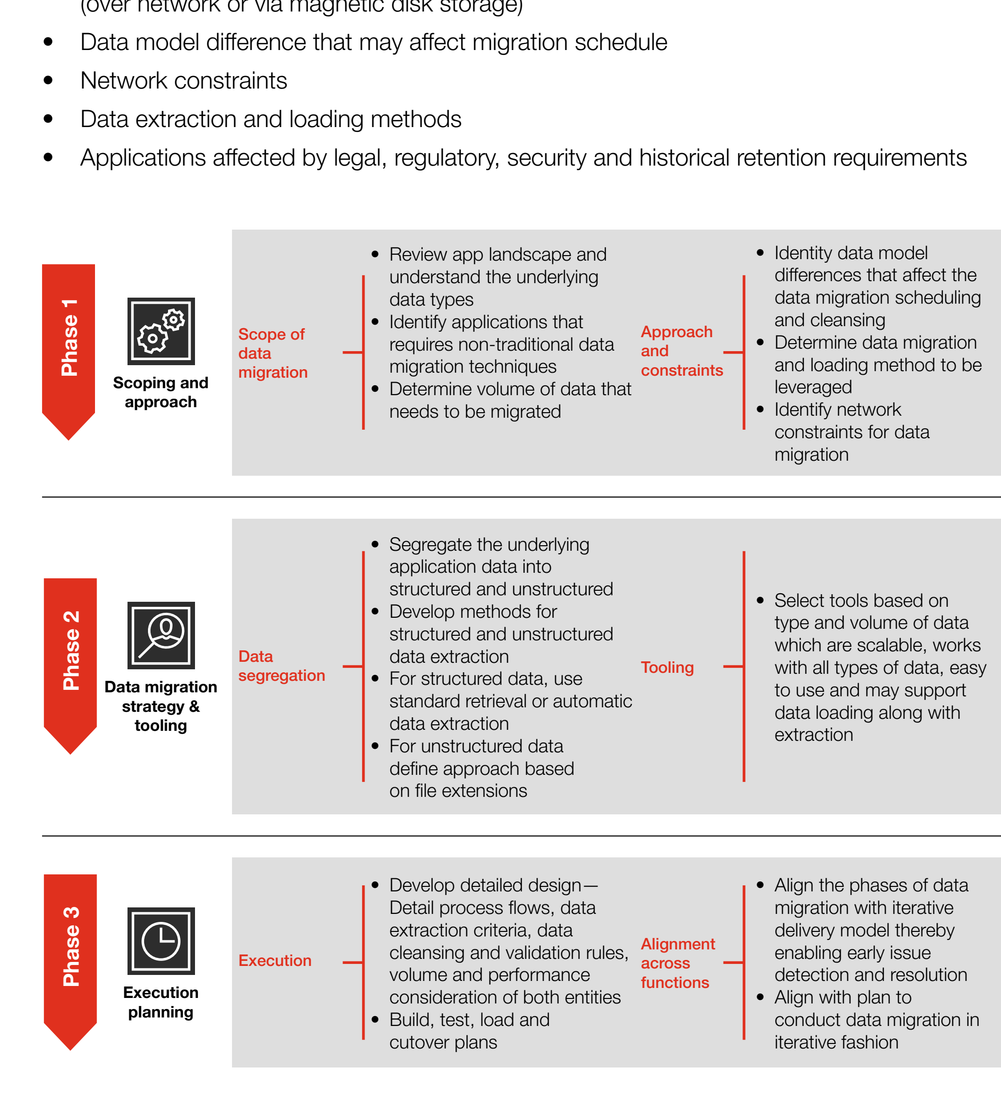
- Changing business processes (e.g., US GAAP and IFRS)
- Adapting different IT landscapes (different ERPs)
- Compliance with tax, legal and security considerations (e.g., data archival requirements)
- Preventing the migration of unnecessary data
- Complex reporting requirements
- Managing structured and unstructured data
- Infrastructure constraints (e.g., network limitation)
- Diverse resource requirements (e.g., SMEs, architects)

Data migration approach for divestitures

Data migration requires a business process oriented approach. It should consist of three phases with an overarching project management function (as shown in the image below):

Phase 1—Determining scope of data migration: This involves analyzing the process and application landscape to understand the conversion needed to migrate data from the Parent. A process to application mapping helps identify applications that are unavailable for key subprocess either at the Parent or the SpinCo alerting the data migration team that innovative solutions are required to manage the data. Once mapping is complete, IT team should review the applications to understand:

- Underlying data types
- Difference between applications used by Parent and SpinCo
- Volume of data that must be migrated and how data will be moved (over network or via magnetic disk storage)
- Data model difference that may affect migration schedule
- Network constraints
- Data extraction and loading methods
- Applications affected by legal, regulatory, security and historical retention requirements



Phase 2—Data migration strategy definition and tool setup:

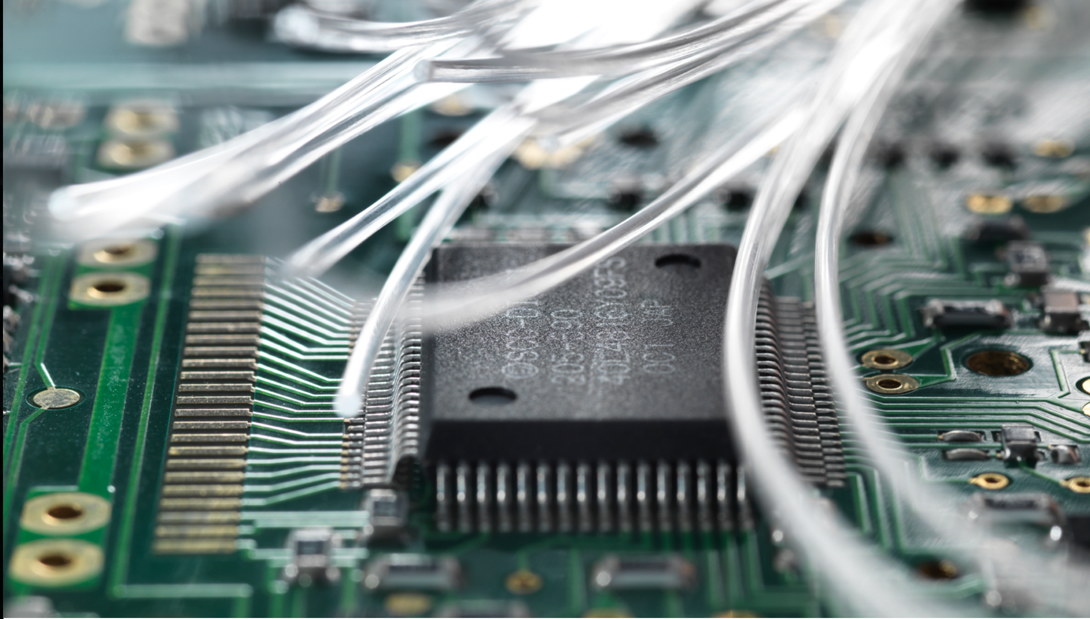
Data migration involves the following three-step extract, transform and load (ETL) process.

- **Extract—**Extract process involves extracting data from Parent's IT landscape into the staging area for both structured and unstructured data. Before extraction, the team should perform an assessment of Parent's IT landscape. This assessment includes data profiling (identifying data not fit for migration), data quality (data properties and interrelationships) and data cleansing
- **Transform—**Transformation is the phase in which business rules are applied to synchronize the Parent's data with the data structure of SpinCo. Data is often loaded onto a staging area and then data conversion rules are applied for consistency. Data conversion includes changing data formats, changing data attributes, joining or splitting data, applying data quality and validation checks and applying required data security rules.
- **Load—**Loading is when transformed data is pushed into the SpinCo's data stores. Loading techniques may differ based on data type, application type, data volume, information security rules and network capabilities.
  - Transactional and relational data can be moved into target systems via scripts using tools such as Informatica or Mulesoft.
  - Structured or unstructured data can be migrated into target systems using magnetic disk storage tapes that can be shipped.
  - Data extract (e.g., files) can also be stored and migrated using Secure File Transfer Protocol (SFTP) batch transfers.

Phase 3—Data migration execution

Data migration execution should align with the iterative delivery model, thereby enabling early issue detection and resolution. Key steps include:

- Plan the execution (deliver data migration scripts for process and subprocesses with appropriate resource engaged across migration design, test and delivery pipeline).
- Define the design (work with business and IT architects to develop design at data element level).
- Build data migration scripts and procedures.
- Conduct unit testing to cover validation of target data stores and data, test security and evaluate system performance.
- Perform business validations with SMEs and receive sign off.
- Perform pre-production validations in production like environment.
- Cutover (works with deployment and cutover team to ensure that appropriate procedures and time windows are in place for data migration).



Contract separation

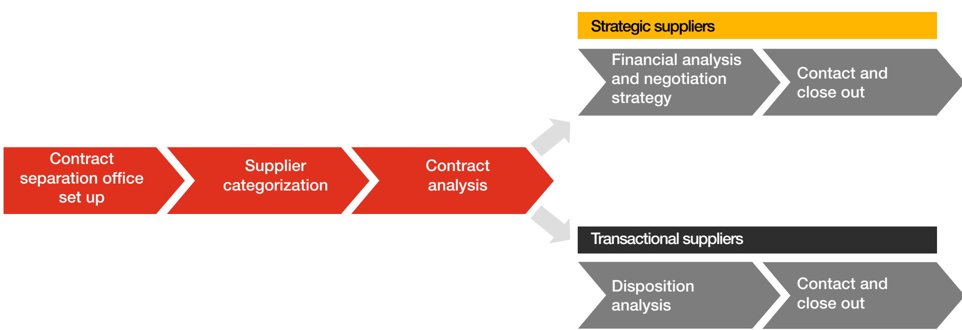
As IT applications and infrastructure are separated for transaction, the underlying third-party IT contracts also need to be separated. These are highly intertwined across the organization and can be a source for significant cost reduction during separation.

For multiple reasons, IT contracts are among the most complex and challenging aspects of an IT separation.

1. **Large set of contracts and disparate set of vendors:** Depending on the size of the company, the number of contracts in their inventory could go into the thousands. Companies are often not strategic about their procurement and contractual needs, and do not have a centralized procurement team that manages multiple contracts. Additionally, the number of vendors in scope tends to be large and follows the Pareto principle (80% of suppliers contributed to a small portion of the spend).
2. **Huge separation costs:** Contract separation involves multiple cost aspects including one-time transactional costs, changes in operational expenses due to separation, stranded costs and dis-synergies.
3. **Changes to future state:** As RemainCo and SpinCo define their post-separation future state, certain contracts may not be required or may need changes and renegotiations due to changes in requirements.

Taking a structured and strategic approach to contract separation will avoid the risk of significant costs in lawsuits or vendor renegotiations and ensures smooth business operations post separation.

Contract separation framework



1. Contract separation office setup

A contract separation office enables a structured and streamlined approach to contract separation, working with internal and external partners to separate IT contracts. This team supports in identifying business objectives of both RemainCo and SpinCo entities. They document and collect critical parameters across contracts, assess contract inventory, evaluate vendors, and negotiate and communicate with them.

Critical activities include:

- Identify the scope of contracts across the business units, namely HR, Finance, IT, Marketing and Sales.
- Evaluate the contract documents and document key parameters across the contracts.
- Identify strategic and transactional suppliers based on spend or criticality of underlying business process.
- Search for key data fields terms and extract values.
- Identify contractual restrictions to expedite contract negotiations.

2. Supplier categorization

Once a contract inventory is created, the contract separation office assesses the list of contracts and classifies vendors into strategic or transactional suppliers.

Strategic suppliers are those that provide assets or services which are critical to operations. These contracts are typically complex, high value contracts. Transactional suppliers on the other hand provide assets or services which are needed for Day One but are not critical nor complex.

3. Contract analysis

The contract separation office then analyzes contractual parameters and key contractual clauses to determine Day One strategy/approach for each contract. The approach is different for strategic suppliers and for transactional suppliers.

Key steps in contract analysis—Strategic suppliers

- Develop financial analysis and identify strategies for negotiating with strategic suppliers.
- Initiate communication and complete negotiations.

Key steps in contract analysis—Transactional suppliers

- Develop the disposition of suppliers based on their current and future scope of work.
- Develop communication for the suppliers based on their disposition.

Transition service agreements (TSA)

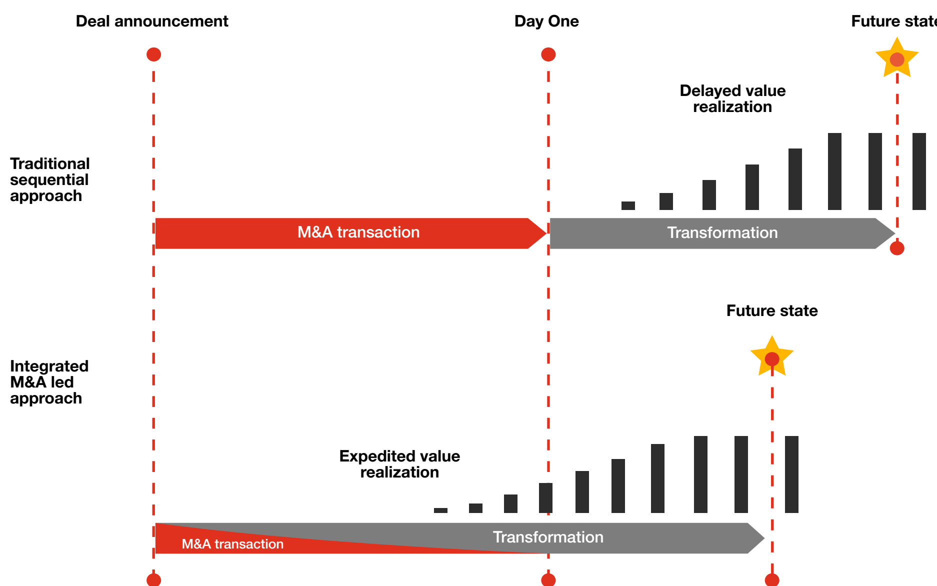
The importance and criticality of transition services agreements (TSAs) is outlined on Page 60 as well as the process for developing and managing TSAs. IT often has the largest scope, cost and interdependencies across functions and the longest durations for TSAs. Engaging IT early in the planning process is key to understanding spin timing constraints and costs.

"Transact to transform" approach to enhance deal value

Spin-offs provide organizations with unique opportunities to transform and optimize their business operations and processes. A limited or targeted transformation can help organizations to reduce the need for TSAs, reduce the cost profile of the divested businesses and provide divested entities with an underlying business process that is "fit for purpose" for the size and nature of the company. This can play a critical role in the divestiture scenario for SpinCo to see efficiency and eventually enhance deal value.

To fully derive the benefits of the transformation, the timing of the transformation along with detailed planning is critical. An end-to-end transformation usually requires anywhere from 12 to 24 months to complete including build, test and deploy cycles. Most companies who begin the transform journey earlier get more value.

Expediting value through "transact to transform"



Benefits of “transact to transform” approach

A “transact to transform” approach can benefit both RemainCo and SpinCo and lead to enhancement of overall deal value. In addition to simplified business processes, optimized architecture and reduced G&A cost, there are specific benefits for both buyers and sellers.

Key benefits for SpinCo:

- Robust capabilities aligned to industry standard process
- Fit-for-purpose architecture and lean operating model
- Reduced IT operational expense
- Expedite value realization/business benefits
- Instill M&A rigor and speed into transformations

Key benefits for RemainCo:

- Lower system entanglement and cyber risk exposure
- Limited and shorter TSAs to SpinCo, providing flexibility for RemainCo
- Optimized one-time separation cost due to planned transformation
- Creates engine for future M&A
- Reduce number of transitions and change management effort

For more information on delivering value on your divestiture and IT separation, please contact:

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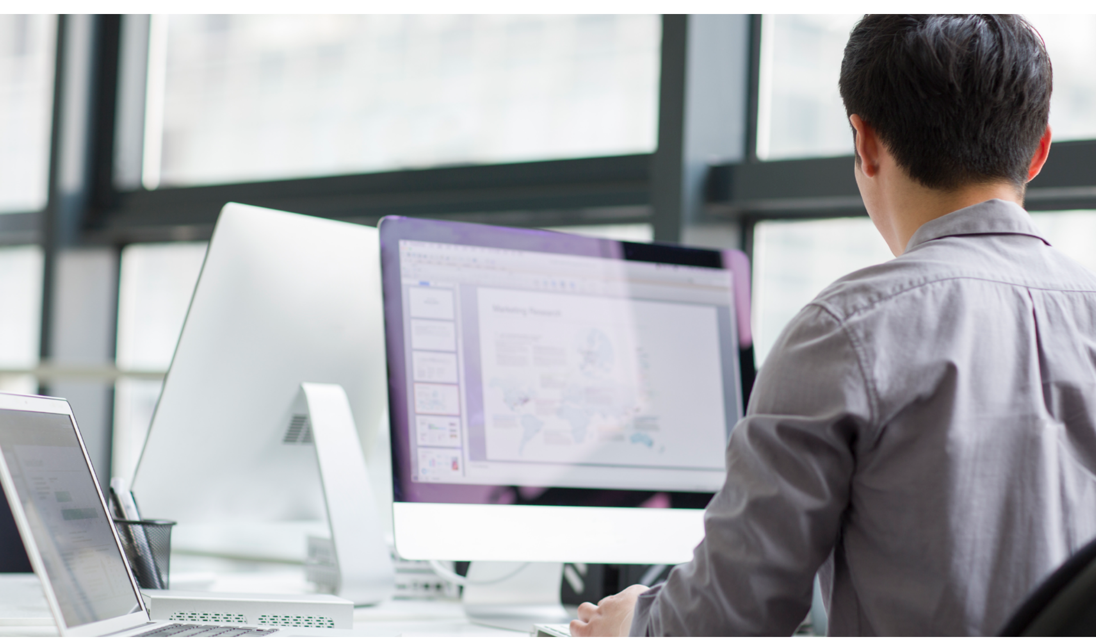


Human resources

Regardless of the business reason for a spin-off, SpinCo, and in particular the HR function, must address critical issues that if neglected or not managed appropriately can result in erosion of deal value. HR must juggle standing up a new HR function, engaging and retaining employees, designing a new organization, managing people-related liabilities and compliance to local legal requirements.

In this section we cover:

Managing in-scope employees

Early identification of in-scope employees is fundamental for preparing accurate financial and operational information for SpinCo.

HR financial modeling

Much like the business and other enabling functions, HR must assess one-time costs and financial exposures as well as impacts to P&L cost and future cash flow.

HR transition service agreements (TSA)

Delivering HR TSAs requires an understanding the scope, costs and resources required to support the divesting business and what is required to operate on Day One.

Benefits

Design and implement benefit plans organized around SpinCo's new legal entity structure that meet all statutory requirements and employer contractual obligations while delivering market competitive value that will motivate and retain employees.

Compensation

Plan for future changes. Address the impact of the spin on future SpinCo employees who were participants in Parent equity programs.

Payroll, HR technology and operations

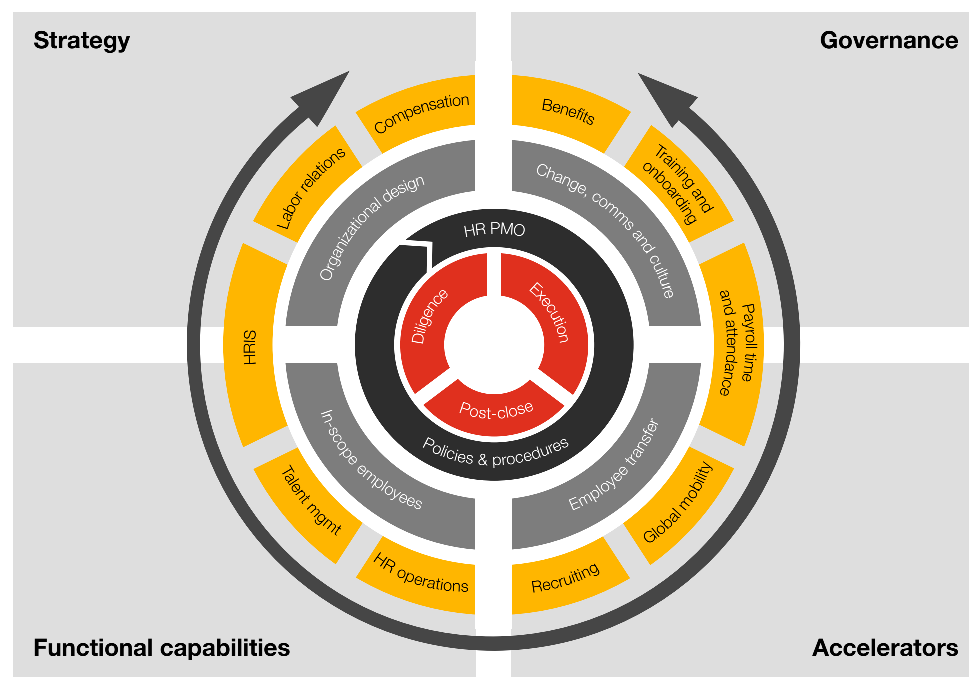
Establish a "fit for purpose" HR function with payroll, HR Systems, policies and resources to deliver for SpinCo at the right price.

Employee transfer, labor relations and global mobility

Understand SpinCo employee transfer implications, employee data management and labor unions/works councils' obligations in compliance with local legal requirements.

Talent management and retention

Get ahead of adverse attrition. Engage pivotal talent early and manage a transparent talent selection process with an eye for capabilities and metrics aligned with culture and requirements for the new organization.



Managing in-scope employees

Identifying in-scope employees is more than pulling together a census for the business to be spun off. It is part of talent mapping and selection, which is a key component of overall organization design. Organization design and selection of in-scope employees forms a foundation for developing accurate financial and operational information for the divested business. It presents HR and the business with an opportunity to determine gaps, begin gathering relevant data and ensures processes are in place to comply with local legal requirements in multi-jurisdiction deals. Accurate in-scope employee processes elevate accuracy of employee financial data for a stand-alone business reducing the risk of downstream surprises and adverse price adjustments. For more information on delivering value on your divestiture and IT separation:

Selecting in-scope employees	Key considerations	Managing spin-off risks
• Establish and communicate a threshold for designating employees to the divested business, e.g., employees spending 75% or more of their time on the business are automatically allocated. • Determine early how shared services employees will be allocated. • Understand key roles or skill sets that may need to be negotiated out of existing employee pools.	• What are the key implications and related costs for employees in different jurisdictions, e.g., pensions, agreements, unions, works councils, expats and Transfer of Undertakings Protection of Employment (TUPE) requirements? • What relevant employee information can we start to gather to support the spin-off? • What are the greatest new hire needs that cannot be filled by current in-scope employees? • How will retention of critical employees be managed?	• Establish stand-alone costs based on actual employees and associated costs rather corporate allocation alone. • Provide adequate demographics to enable full understanding of liabilities. • Gather performance metrics and employee satisfaction to help gauge stand-alone skill gaps and retention risks.

Early and accurate identification of employees affords an opportunity to thoughtfully plan for the spin-off and manage employee related risks. Combined with early analysis of key information, it allows HR to understand potential losses that could be incurred by employees, e.g., opportunities to vest in pensions and stocks, and provides a longer runway to build solutions, manage legal implications and plan employee and labor communications around such topics as retention strategies.

HR financial modeling

Having identified the in-scope employees of the business, HR must begin to assess one-time costs and financial exposures as well as impacts to P&L cost and future cash flow. Understanding human capital-related financial inputs requires an examination of workforce issues such as impacts to compensation programs (e.g., competitive base compensation, equity and other incentives), pension and benefit plans and relations with organized labor. In addition, HR function-specific considerations will include one-time and run-rate costs related to operational changes at RemainCo and SpinCo. The presentation of go-forward human capital costs including limitations on exposure are integral to maximizing the financial return from the spin-off.

A sound human capital stand-alone financial model starts with understanding the key components that make up employee-related costs as well as careful consideration of decisions and structures within HR control. HR should be concerned with matters such as transfer of pension liabilities and assets, deal bonus triggers, changes to benefit run-rate cost due to separation and changes to the respective HR operating models of the divested business and RemainCo. As HR and finance collaborate on a stand-alone model, their strategy and work process must address three key questions:

1. How will the model and analysis provided assure deal counterparties of the financial value inherent in the business in a way that is tailored to the concerns of the stakeholders?
2. Are sources of financial uncertainty or exposure understood by RemainCo representatives such that strategic dialogue and disclosure can effectively address and put bounds around them?
3. What are the aspects of the deal structure at RemainCo that will have an impact on the overall deal value to RemainCo? (e.g., retention of liabilities, creation of stranded costs, dis-synergies due to descaling of shared services, resource constraints or distraction due to execution of operating model changes)

Key cost components	Key considerations	Financial implications
Compensation	• Will employees lose the opportunity to vest in pension benefits or have unvested or stock options? How much is at stake to be lost? • What are the incremental costs triggered by merit increases, potential promotions and what is the timing?	• SpinCo may consider providing replacement value for lost awards and understand obligations and liabilities. • SpinCo will factor incremental costs resulting from contractually required payments into its stand-alone model and understand obligations. • Payments that are structured to require a period of continued employment with the company post-close may be more attractive to the SpinCo for their retention value.
Benefits and pensions	• Will employees lose the opportunity to vest in pension benefits or have unvested or stock options? How much is at stake to be lost? • What are the incremental costs triggered by new organizational roles, e.g., new CFO, merit increases and what is the timing?	• Historical benefit allocations to a carve-out are rarely made on the basis of a realistic pro forma stand-alone cost. In practice they will typically vary on the order of 5% of payroll expense in either direction. SpinCo should design its strategy for disclosure around knowledge of the variation and potential for future change. • Understanding the magnitude of pension assets and liabilities subject to mandatory transfer and the competitive practices regarding placement of pensions where latitude exists are key to maximizing deal value and reducing the Parent's future risk portfolio.

Key cost components	Key considerations	Financial implications
HR systems and operations	• Which HR services and systems will the divested business need to continue operating and at what cost? • Can HR functions, systems and assets be transferred to the divested business and are there other more cost-effective options?	• RemainCo is best placed to understand its systems and operational capabilities and limitations vis-à-vis service delivery to the in-scope workforce. As such, it has an opportunity to present a model (or alternatives) that maximizes future business run rate, and establish HR operations that are demonstrably both realistic and market competitive.
One-time costs, synergies and di-synergies	• What are the one-time costs associated with setting up payroll, time and attendance, Human Resource Information System (HRIS), recruiting and onboarding, compliance and communication? • Where are potential synergies or dis-synergies to be realized, e.g., expanded scope of responsibilities for employees or additional required headcount?	• Based on timing, budget and profile, RemainCo must determine the degree to which it readies the divesting business for separation. Key to this determination are quantification of one-time costs, consideration of whether they should be incurred either by the SpinCo or RemainCo and ability to execute on stand-up activities (vs. performing on TSAs) in the face of competing priorities. • Considering potential descaling of shared services and changes to service delivery and individual roles, the RemainCo should make a high-level effort to quantify the net changes to functional labor cost both for the divested entity and RemainCo.

HR should consider all employee-related costs and potential obligations and prepare to help SpinCo also understand:

- **Potential changes to employee compensation** and assess if significant future changes are required, e.g., competitiveness of compensation. Will increases be warranted to make stand-alone business more attractive to employees in comparison to industry peers?
- **Employment agreements and any obligations** or risks that they may be inheriting. For example, severance obligations relating to former employees, payments and terms agreed to in employment agreements and expatriate agreements.

HR must think ahead of other implications that may substantially change costs which may impact the financial decision-making process for the stand up of SpinCo.

HR TSA

TSAs are for the most part inevitable for HR, especially on large complex global deals. The TSAs are needed to protect divested employees at close. It is imperative that HR understands the importance of potential HR TSAs for the stand-alone business with the intent to properly manage the TSA, ensure cost recovery and make sure they are prepared during negotiations to commit only to services they can support.

Common HR TSAs provided to SpinCo

Common	Minimal	Common exclusions/avoided
• Payroll administration and processing • Benefits administration • HRIS/data management • Learning management system • HR operations/services administration	• Recruiting • Training • Compensation • Expat and foreign nationals service administration	• Compensation • Collective bargaining negotiations • Expat tax services • Performance management administration

Delivering HR TSAs requires clear understanding of upfront limitations, scope of TSAs, costs and resources required to support the divesting business as well as managing appropriate dependencies with legal, tax, etc., to ensure you have the resources to execute. A proactive approach starts with determining HR services that will be required to operate on Day One, understanding SpinCo needs and internal capabilities to reduce employee and financial exposure for the remaining business.

Anticipate SpinCo's needs	Protect RemainCo
• Determine if HR functions, systems and services can be transferred to the divested business and if cost effective third-party options are available to provide services. • Prepare for multiple scenarios and durations. • Understand the resource requirements to support the TSAs and clarify roles and responsibilities (administrative vs. managerial responsibilities).	• Have clear direction on acceptable durations for TSAs and applicable penalties when the duration is extended. • Understand the impediments to providing a TSA e.g., permissibility issues in different jurisdictions, e.g., restrictions on payroll processing or funding) or benefit plan laws that make providing TSAs difficult e.g., multi employer plan rules. • Understand employee data privacy rules in all relevant jurisdictions. • Understand the resource requirements to support the TSAs and be clear on roles and responsibilities (administrative vs. managerial responsibilities). • Clarity on TSA costs are well understood and consider costs to make changes to support the SpinCo such as benefits changes and stranded cost as well as responsibility for stranded costs.

HR should look to prepare beyond capabilities and infrastructure to support TSAs. They should also be prepared to advise on Day One HR service delivery models and capability gaps, including designating priority hires for both HR and business functions and determine the level of support that will be needed to accomplish Day One priorities.

Benefits

The second largest labor cost driver (after salaries and other forms of compensation) is comprised of benefits that are granted to employees. Benefits are granted to employees for a wide variety of reasons, including:

- To allow for the health and well-being of the workforce and families
- To allow retirement of employees at a reasonable age
- To meet the requirements of local laws or labor agreements
- To attract and retain talent

The above goals are often in stark contrast both to controlling cost and managing risk. For example, defined benefit pension plans form the gold standard for providing retirement benefits that allow career employees to retire at a reasonable age with a generous level of replacement income. For the employer, however, these plans will bring a large degree of balance sheet volatility together with high and unpredictable cash costs. Given such competing pressures, in a spin context, the Parent should work to establish a balanced benefit strategy that fits the business plan for SpinCo.

In designing SpinCo benefits, mandatory requirements should be considered first. Mandatory requirements will be driven primarily by local statute and any labor agreements (with unions or works councils). To the extent requirements are determined to be either onerous or costly, this may be a good time to reconsider the geographic employee footprint for SpinCo. This is especially timely to consider as SpinCo may not have the same risk tolerance or budget that Parent once had at a larger scale.

After meeting any mandatory requirements, discretionary matters concerning go-forward benefit design and cost must be decided. The primary goal for this part of the effort is that the new overall benefit design fits with the business plan of SpinCo. Secondarily, continuity with prior Parent benefits may be desirable, but must always take a back seat to SpinCo's new business needs. In this section we will discuss the two key areas that will most often need to be considered in the context of a spin: health and welfare benefits, and defined benefit plans (pensions and other post-employment benefits).

Health and welfare benefits

Health and welfare (H&W) benefits include but are not limited to: (a) medical plans, (b) dental plans, (c) vision plans, (d) life, accidental death and dismemberment insurance plans, (e) long-term or short-term disability insurance plans, etc. These benefit costs are often material (especially in the US where the Affordable Care Act sets mandatory minimum coverage standards). Costs allocated to the business being divested pre-spin may not be a good proxy for go-forward SpinCo costs. During planning, the financial allocation methodology should be assessed and adjusted to reflect a best estimate of costs for the spun population. The potential granularity of the estimates will in part depend upon the availability of good data for the divesting business: e.g., historical claims data for the SpinCo population.

The following points should be considered during planning:

- SpinCo legal entity sponsorship of plans
- Past methodology used to allocate costs to SpinCo business
- Run-rate costs, past incurred versus go-forward budget
- Actual enrollment and claims experience of SpinCo employees
- Stand-alone adjustments for administration and insurance
- One-time costs to establish any new plans needed
- Balance sheet treatment including potential acceptance of Incurred But Not Reported Claims (IBNR) by SpinCo or fresh start due to retention of IBNR by Parent
- Timing to separate any entangled plans: post-spin-off, any plans sponsored jointly by Parent and SpinCo create risk, especially in the US

Note that H&W benefits tend to be less financially significant outside of the US, where only supplemental coverage beyond government provided social insurance is usually provided. In any given spin this should be investigated in each jurisdiction using allocated P&L and payroll data for SpinCo employees as initial points of reference.

Defined benefit plans (pensions and other post-retirement benefits)

The common characteristic that all defined benefit (DB) plans share is a formulaic employer promise to provide certain benefit entitlements at some future date (usually the retirement of the employee). By far the most common form of DB plans are pension plans which pay retirement replacement income. In this section, we will discuss the appropriate treatment of pensions in the context of a spin-off. The principles discussed are equally applicable in general to other DB plans, which are generally much simpler.

DB pension plans as entities have both liabilities and assets. The liabilities are the present value of retirement income promises that have been made to employees while the assets are investments (usually in a trust) that have been set aside to meet those promises. Treating pensions in a spin can be dealt with in a series of three general steps:

1. **Define the future state rate of pension promises (i.e., service cost) that will be granted to SpinCo employee—**In defining future state promises, benefit levels required by statute or other agreement (e.g., labor, employment) must first be considered. In general, if ongoing DB pensions are not required, a spin is a good time to replace them with some form of defined contribution (DC) arrangement. Because there is no easy way to equate DC benefit levels to prior DB ones, it is often possible to have something close to a fresh start where the DC plan contribution levels are set primarily to be market competitive.
2. **Define the future sponsorship structure—**The easiest cases are situations where SpinCo already sponsors its own plans. If not and there will be ongoing DB pension benefits for employees, plans must be established at SpinCo level. Even if there are no ongoing pension accruals, in cases where past liabilities or assets will be transferred, new SpinCo plans must be set up.
3. **Transfer assets and liabilities to SpinCo plans—**This is the most critical step of the three as it generally relates to the most significant portion of the historical liabilities. Whether or not ongoing benefits are required, the benefits earned in the past must be addressed. As with other matters, the first question is whether there are any statutory requirements that must be met. For example, some European countries (e.g., Germany, UK) have requirements as to how assets and liabilities be divided between Parent and SpinCo. Where there is discretion, a leading practice is to work with actuaries on how to divide assets and liabilities between Parent and SpinCo. It is also often valuable to treat the division of liabilities and assets as separate matters. With regard to liabilities, there is a balance between removing Parent obligations while at the same time not overburdening SpinCo. And asset allocation may vary for SpinCo plans versus historical practice of Parent. Actuaries can assist with modeling and stress testing various scenarios from various stakeholder perspectives.

Compensation

As with benefits design matters (discussed above), go-forward compensation design and cost for SpinCo must be planned for. Unlike the case with benefits design, however, there will be a greater emphasis on maintaining continuity as of the effective date of the spin-off, and often for a defined period of time thereafter.

The most common rationale for this is that it would be disruptive and likely difficult to reduce current compensation for spun-off employees due to deal agreements and state, local and/or possible union restrictions. In a case where there is a contemplated increase to spun employee compensation, it is important to assess criteria such as criticality to the deal, changes in scope and responsibilities associated with new roles in SpinCo, etc., which may necessitate compensation changes.

To the extent changes are needed, these should typically be rolled out in a controlled manner and should be done in a way that considers all financial impact to the organization. Sometimes compensation changes are made at once, and sometimes they are made over a defined period of time. Because future compensation design must closely follow SpinCo's business strategy (which could be very different from Parent), the range of alternatives for setting potential future cash pay and bonus designs is beyond the scope of this guide. Such planning should be done in collaboration with advisors who are compensation specialists and should be based on the go-forward compensation philosophy of SpinCo. While compensation in general will typically remain continuous, one area that often needs to be addressed during the spin is treatment of equity or equity-like plans.

Equity compensation (and similar) plans should be reviewed to determine the type of stock, equity or other award granted to employees of the spun business and the consequences of the spin on the awards, together with any associated retention considerations. In particular, the area of focus should be around treatment of awards that would otherwise be unvested as of the effective date of the spin-off.

The treatment of unvested equity upon a spin should be dictated by the terms of the equity plan, but the plan may provide discretion over treatment. Companies will generally modify outstanding awards to keep employees in the same economic position after the spin-off.

Companies can use a number of ways to keep employees "whole" after a spin-off. Each approach can result in a different accounting impact to SpinCo such that the Parent should be aware of the implications. For example,

- **Discretionary acceleration:** This approach may result in post-spin P&L expenses for SpinCo, even if the Parent were to accelerate (and cash out) all equity-based awards as of the spin-off.
- **Rollover of unvested awards** into a new equity program or deferred-compensation vehicle sponsored by SpinCo: This approach may result in a post-spin-off P&L expense but will also have retentive benefits beyond the effective date of spin-off.
- **Forfeiture of unvested awards:** This results in a loss in value to the equity holders, which is an important consideration point vis-à-vis retention. This approach is most typical where the entity being spun is a subsidiary of the Parent and the equity SpinCo management has received is denominated in the stock of the Parent.

Regardless of the methodology selected, an adjustment of equity awards should be treated as a modification under ASC 718. Accordingly, planning for various scenarios should be done in close collaboration with advisors who are deals compensation specialists.

Payroll, HR technology and operations

Divesting the business requires HR function and/or service agreement in place on Day One to ensure employees can be paid, benefits and pensions funded, and the infrastructure is in place to manage employee services and ensure compliance with local legal requirements. The right technology solution is critical for managing employee data and downstream processes such as payroll, time and attendance and key business systems required for employees to perform their roles.

Payroll and time and attendance

Cross-functional collaboration with finance, HR, IT, tax, the SpinCo and third-party vendors is needed to ensure employees can be paid at close and the divested business remains in compliance with local legal requirements. The ability to run dual payroll may be required (remaining business and divested company where TSAs are provided), including tax and payroll filings, and benefits and social security requirements. HR must ensure the function has the right level of resources to fulfill these obligations. HR should also understand impediments to providing or receiving payroll TSAs and ensuring permissibility to deliver services or make payments on behalf of the divested business.

Payroll and time and attendance require a clear plan with cross-functional owners and the appropriate time for set-up of tax registrations and banking arrangements in each country and conduct required testing to ensure there are no issues with paying employees. The plan should include:

- Establishing a clear strategy for separation of systems and vendors associated with processing payroll and time and attendance
- Inventory payroll systems, policies and processes to establish Day One stand-alone/TSA requirements
- Setup of appropriate TSA arrangements, where required, to ensure that all in-scope employees can be paid accurately
- Setup of new banking and treasury arrangements as needed for the new established entities ensuring that any new Employer Identification Number (EIN) structure is accurately setup for payroll processing
- Ensuring that interdependencies between payroll, T&A, HRIS (system of record), finance (GL/Tax/Treasury) and benefits (deductions) are addressed
- Establishing tax processing and administration arrangements as needed for the new divested entity
- Coordinating the payroll systems separation with overall technology/IT separation roadmap and also ensuring this is coordinated with talent management and benefits administration systems separation
- Conducting extensive end-to-end and user acceptance testing to minimize errors on system transitions and migrations

HR technology

HR must understand Day One requirements for supporting HR technology and operations, including cloning of systems, where applicable. HR should also understand the extent of the HR technology system modifications if needed to support TSAs, data compliance and other vendor requirements. A comprehensive inventory of all HRIS systems, policies, processes and cross-functional dependencies is an important early step in planning the transition.

The scope of HR technology workstream includes but is not limited to strategy around systems, vendors and contracts associated with the core system of record—Human Resources Information System (HRIS) and:

- Supporting technology for talent management (e.g., performance management, recruiting and applicant tracking, compensation and succession planning)
- Other applications/vendors associated with reporting, employment verifications (background, drug screen), personnel files systems
- Interfaces or connections to other downstream systems—(HR and enterprise) as applicable—e.g., payroll, benefits, time and attendance, finance, travel and expense

Day One planning for the divested business must take the reality of the new business requirements into consideration,

- Establish data management and governance protocols early and inventory all systems, policies and processes to establish Day One stand-alone/TSA requirements.
- Establish the protocol needed for separating in-scope employees from HR systems and ensuring access as needed post-close.
- Ensure that separation needs for reports and interfaces with commingled data are identified and accounted for in the separation planning.
- Ensure that the HR technology separation strategy and timeline is aligned to timelines for interdependent functions and workstreams.
- Conduct extensive end-to-end and user acceptance testing to minimize errors on system transitions and migrations.
- Identify the technology gaps that continue to exist with respect to the SpinCo HR infrastructure systems, capabilities and processes and establish and evaluate the HR technology options that can provide solutions.

HR operations

When planning HR operations for Day One, the deal team needs to consider the scope of the delivery model for the divested business and streamline HR processes as required. The overall intent is to ensure that HR services can be delivered for SpinCo effectively and efficiently for Day One and beyond. Specifically, this requires determining how best to separate the HR function delivery (including systems, processes and policies that support the delivery) from the existing Parent HR infrastructure. The HR service operating model must be defined and adjusted to meet the needs of the new organization. Once the HR delivery model is finalized, then it is important to align the HR infrastructure to support the delivery of HR services:

- Use benchmarking data to understand what similar size companies are spending on people, process and technology relative to peers in order to define the new HR operating/service delivery model.
- Proactively identify HR services the divested business will need to continue operating seamlessly upon separation to help understand services that can be delivered and manage costs effectively—some of these may need to be supported via a TSA for an interim time period.
- Assess feasibility of HR shared services.
- Inventory current HR policies and procedures and understand any divestiture related implications.
- Understand the sequence of HR activities and interdependencies throughout the divestiture process to ensure business continuity within RemainCo and establish the right fit HR function and services for the new organization.
- Utilize leveraged purchase agreements, wherever possible, to minimize stand-alone costs.
- Minimize vendor footprint while maintaining operational efficiency and reducing Day One execution risk.
- Leverage out-of-the-box, leading practice processes. Avoid customizations.

Employee transfer, labor relations and global mobility

Multi-jurisdictional deals implicate complex employment law issues. In any cross-border deal, despite some regional commonalities, the answer will differ. HR function should have cross-border divestment teams and engage the right counsel to ensure compliance and avoid triggering liabilities and fines correctly.

Legal entity establishment and registrations

Legal entities are the cornerstone of any transactions that enable the transfer of assets and legal operation of the business. HR will need to:

- Provide data and input into establishment of employee holding legal entities for RemainCo entities and provide relevant data to set up new entities, e.g., employee threshold that trigger work councils or trigger liabilities such as benefits and compensation requirements.
- Plan ahead and gather relevant data to ensure ability to execute on employment-related registrations as soon as legal entities are established. Failure to have prerequisite registrations complete on time may delay transfer of employees as payroll, benefits, etc., setup cannot be completed without relevant registrations in place, e.g., Social Security, worker compensation and payroll tax identification. Registration and lead time required to compete differs by country.

Labor relations

Maintaining business stability and operational continuity are critical to preserving deal value. Labor action can derail or slow down the separation process, therefore you should:

- Establish a negotiation strategy early to understand labor concerns and anticipate issues/challenges, including changes in benefits, continuation of service, redundancies and even changes to policies, e.g., travel and cafeteria.
- Understand deal parameters and align key stakeholders early: HR, finance, legal and deal team. Understand end-to-end deal processes that will be of relevance to labor bodies, e.g., employee transfers, compensation and benefits, change of control processes and whether any past agreements would trigger severance such as existing social plans.
- Consider regional, geographic and economic conditions that may impact negotiations and consultations. Understand the time typically required to complete negotiations in different countries and regions.
- Map labor consultation requirements and ensure compliance with local laws and collective bargaining agreements, e.g., work councils and consultations to inform of employee impact and obtain and decisions, at least three months for consultation process.
- Avoid piling on deal consultations with other company matters as it will jeopardize close or could be used to bargain for other changes.
- Budget early for concessions, while working to avoid any monetary concessions. Use as a last resort.

Employee transfer process

As with labor relations, employee transfer processes require close collaboration and agreement. You should:

- Plan early and understand jurisdiction-specific end-to-end employee transfer processes and requirements.
- Manage and execute on intermediate moves such as the transition of remaining employees from divested entities.
- Engage legal counsel with knowledge of specific jurisdictions' requirements and potential land mines triggered by decisions, e.g., terms and conditions, seniority, notice period, work councils, severance triggers, employee contracts change, etc.
- Understand additional local filing requirements, and understand and plan for financial liabilities triggered by transfers early, e.g., severance responsibility, individual employee bonuses and agreements, collective bargaining agreements.
- Move employees to the correct legal entities ahead of time, ensuring compliant transfer letters, movement of visas and employee contracts as well as vendor implications such as benefits and payroll alignment and tax liabilities.

Expatriates and foreign nationals

Having an accurate and full understanding of the scope of employees on company-sponsored visas as well as expatriates, including expat arrangements and visa type, is imperative. Be sure to identify the following:

- Expat agreements in place, including bonuses and benefits, e.g., housing, healthcare, schooling, travel, tax services, etc.
- Accurate costs associated with supporting expats and ensuring support of foreign nationals
- Work permits tend to have a long lead and pose the biggest risk to delayed employee transfers. Plan early and begin transition processes as soon as possible, and communicate and engage impacted employees early.
- As with other deal processes, visas require close collaboration with legal counsel and, in the case of expats, tax services and legal entity establishment.

Data privacy

Align the legal and corporate development team to ensure compliance with data privacy requirements, particularly as they relate to employee data on multi-jurisdictional deals. Make sure you:

- Understand requirements and liabilities by region and country, e.g., the EU General Data Protection Regulations (GDPR).
- Stay ahead of markets requiring individual employee data consents to transfer employee data and obtain consent early on.
- Provide only relevant data to the right parties at the right time, e.g., do not share employee identifier data without relevant data privacy agreements.
- Understand restrictions around employee data that can be transferred at close, e.g., certain jurisdictions do not allow transfer of employee performance files.

Talent management and retention

Retaining and engaging employees during a spin-off requires a clear articulation of the deal value and helping employees understand what's in it for them.

Talent management

You will need to consider the following in articulating and establishing a clear talent management and retention strategy:

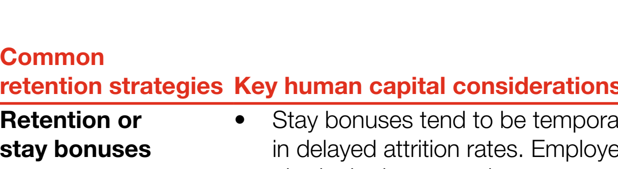
- Are there cultural reasons employees may have a negative perception about the transfer to the SpinCo? For instance, does the Parent have a strong brand reputation in a particular country or is employment at the Parent considered a status symbol in a country?
- Select the right leaders and make leaders and managers responsible for retention and develop robust retention and communication strategy to manage in-scope employees.
- Partner early with the business to identify and manage pivotal talent for SpinCo as well as RemainCo.
- Treat each stakeholder group's concerns individually.
- Establish clear performance measurements and requirements for all roles in the new organization.
- Maintain transparency and establish open communications in the talent selection and recruiting process.

Managing talent and ensuring business continuity is directly linked to managing in-scope employees, change and organizational design processes. You will need to manage both employee and business risks.

- Identify in-scope employees in the planning stages, before the public announcement.
- Make early announcements of strategic review or strategic intent to spin off a business. The announcement affords the opportunity to freeze transfers, address early retirement questions and control hiring and promotions at an earlier stage in the transaction. This can help minimize risks associated with long announcement delays and employee attrition.
- Create a policy or process for managing new hires, transfers into the business unit, redundancies and promotions, etc.

Employee retention

While monetary retention techniques are leveraged, the key to retention is deeply rooted in employee understanding of the future of the company, value proposition and their career. Employees who are nervous about their future will flee. You will need to leverage a balanced use of financial incentives, communication and ensure employees of their future in order to retain employees.



Common retention strategies	Key human capital considerations
Retention or stay bonuses	• Stay bonuses tend to be temporary measures that often just result in delayed attrition rates. Employees tend to stay long enough to obtain the bonus and move on. • Consider coupling the bonuses with clear career direction for pivotal employees. • Identify and “ring fence” pivotal employees early. Retained employees can be grouped into three tiers: 1. Strategic to ongoing business operations 2. Essential to integration effort 3. Essential to transfer of specialized knowledge • Award amounts must take criticality and flight risk into consideration.
Enhanced severance	• Enhanced severance, while not as common as retention bonuses, are leveraged to further assure employees of their criticality in the future organization and address job security concerns. • However, like retention bonuses, if you are not able to convince employees of deal value and the future of the organization, there is potential employees will stay long enough for enhanced severance to kick in and jump ship.
Employee engagement	• Bring pivotal employees under the tent early, assure them of their roles in the future organization—right before or at announcement. • Make business leaders and managers accountable for retention—employ the business leaders to articulate the message. • Establish detailed training and knowledge transfer plans to ensure both remaining and divested businesses do not suffer from a loss of a knowledge that hampers business operations at transition. • Understand cultural implications in different jurisdictions, e.g., how is RemainCo or how will RemainCo be perceived in the local markets? Is RemainCo a status symbol? (Common in central Europe and Southeast Asian countries). How will colleagues perceive new brand, and what are the personal implications?

When considering monetary awards, ensure that incentives are meaningful to employees and deliver the long term goals of the organization:

- **Award size:** Awards can be a percentage of base salary, a flat dollar amount or an amount that increases over time as retention and spin-off milestones are met.
- **Award type:** Cash or equity, or some combination of the two, typically determined by the criticality and retention time horizon of the employee. Strategically critical talent is often offered a mix of different types of equity, reflecting the longer-term commitment to the business expected of such individuals.
- **Transition:** Cash awards are typically paid upon deal close or the completion of a set period post-close. They’re typically prorated if the employee is terminated earlier and knowledge-critical employees receive similar awards, but the payout often requires a longer period of service after close.
- **Payment timing:** The date for receiving the payment(s) should provide a realistic incentive for the employee. Align award payments to the desired employee retention period and criticality, e.g., instalments over the retention period. Leverage earnouts—retention provisions that reward participants for meeting specific performance objectives—within a set amount of time.

The end goal with talent management is employee retention and avoiding a loss of productivity, which can directly impact customers and cause them to flee if mismanaged. Managing employee expectations minimizes disruptions that impact productivity and attrition rates. Providing the right level of information and setting a clear path forward for remaining and divested employees diffuses the grapevine and keeps execution on track. An effective communication process is not stand-alone but embedded into the fabric of how the deal is transacted.

For more information on delivering value on your divestiture and the people side of divestitures, please contact:

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Entity-wide considerations

Good companies require strong leaders to run well. And while the Parent may have had a great board, senior management and communications cadence with the outside world, the new company may require a different fit. Make sure your SpinCo will be around for the long haul by choosing the right leaders, establishing the right governance structure and creating the right communications strategy with external stakeholders to ensure long-term success.

In this section we cover:

Structuring and supporting the board and committees

Make sure each member of the board is a good fit and has the right support. Also, make sure the board is working on a sound legal footing.

Legal matters and dividend policy

There are many legal issues to consider, from trademarks to bridging agreements. And investors will want to know about dividend policy too.

Talking to investors and analysts

Don't ignore the outside world. Investors, analysts and rating agencies will want to know about SpinCo's plans. Communicating at the right intervals and level is critical to managing SpinCo's brand.

Structuring and supporting the board and committees

- **Board of directors—**In the majority of spin-offs, SpinCo will create a board of directors separate from the Parent's. But sometimes the two companies have common board members—often only temporarily—to ease the transition. SpinCo's bylaws will set its board of directors' parameters (including size, range and responsibilities). You should start thinking about the ideal board composition for SpinCo's ongoing needs. Your top management should decide on the mixture of skills, experience and diversity the new board should have—perhaps in consultation with the Parent's nominating and governance committee. That will be a guide when you're recruiting new directors. The other thing you should think about is that if SpinCo will be a non-controlled company, a majority of the board has to be independent. There is a transition period allowed to achieve this independence requirement. But it can take longer than you might think to find the right directors, so this is something you'll want to get started on.
- **Board committees—**All public companies need both an audit committee and a compensation committee. And companies listed on the NYSE also need a nominating and governance committee. Members of these committees must be independent—again, there are transition periods in the rules. The committees also need written charters that include at least the requirements the stock exchanges impose.
- **Support for the board—**The corporate secretary usually organizes board activities. You need to set—and tell people about—board and committee meetings at least a year ahead of time. You also need to prepare and distribute agendas and related material for individual meetings, though most boards now have director portals for securely distributing electronic copies of these. And you need to record the minutes and present them for the directors to approve at a later meeting.
- **Diversity—**The SEC's rules say that, in certain shareholder documents, you need to disclose whether and how the nominating committee considers diversity when nominating directors. But there's little authoritative guidance on how to define diversity. In general, it's best to try to put together a well-rounded board with members who have diverse experience, career paths, educational backgrounds and more. You should also put together a board that's diverse in race, age and gender to give you a broad range of perspectives. In particular, many institutional investors are pushing for greater gender and race diversity on boards and are voting against directors of companies who lack such diversity. For more information on the importance of board diversity and what SpinCo's board can do to increase diversity, refer to PwC's *Board Governance Insights: Boardroom Diversity Should Top Directors' Agenda.*
- **Charter—**You need to decide whether SpinCo's current charter and bylaws meet its needs as a stand-alone company.

The NYSE and Nasdaq generally allow newly public companies a grace period of up to one year to comply with certain requirements relating to director independence. Although only the NYSE rules state that this grace period is available to companies that have been spun off, the Nasdaq indicates that companies that are listing on the Nasdaq can take advantage of a similar grace period.

Useful Tip: Some directors may not make the immediate connection to Environmental, Social and Governance (ESG) issues when considering SpinCo's strategy and board governance responsibilities and think of it as a "nice-to-have," rather than a "need-to-have." But this ignores the growing investor focus on ESG as well as the fact that ESG strategy is about the company's ability to mitigate risk and create long-term value. Make sure SpinCo is set up for success and consider the importance of ESG oversight. For more information refer to PwC's *Board Governance Insights ESG Oversight: The Corporate Director's Guide* and PwC's *Mind the Gap: The Continued Divide Between Investors and Corporates on ESG)*.

Legal matters and dividend policy

- **Legal matters—**The management of SpinCo and the Parent usually work together on a variety of legal matters. The Parent is usually in a position to dictate how to structure the various legal arrangements. Some companies have found it's good to have an independent outside counsel review these legal agreements. Legal matters you might need to deal with include:
  - Trademarks and license agreements
  - Supply and distribution agreements
  - Tax-sharing and indemnification agreements
  - Bridging and service agreements
  - Responsibility for environmental exposures
  - Responsibility for litigation and other contingent liabilities
- **Dividend policy—**SpinCo's board of directors can establish a dividend policy that gives the shareholders a satisfactory cash return while keeping enough liquidity for the company to operate and grow. The dividend strategy is very important because it has a significant impact on both the stock's market price and the configuration of the shareholders—whether, for example, they're institutional shareholders or individuals. Dividend policy is likely to be one of the most common topics for questions at SpinCo's road show meetings.

Talking to investors and research analysts

To prepare for the spin-off, it's important to begin thinking about investor relations and research analyst communications. A few key areas to consider include those below.

- **An investor relations organization—**As a newly public organization, SpinCo will need to foster a significant amount of interaction with the research analyst community as well as with current and targeted shareholders. In order to ensure that there is a consistent message and equity story for SpinCo along with objectives aligned with the Parent, you need to appoint a head of investor relations. They will coordinate SpinCo's communications with investors and research analysts—before and after the spin-off.
- **A strategy for SpinCo's initial road show and investor interaction—**Before the spin-off, SpinCo's executive management will need to go on a roadshow to present the equity story and growth prospects to both current shareholders and target investors. It is important to meet with current shareholders as SpinCo will want them to hold onto their shares in the SpinCo when the stocks starts to trade and with target investors in order to generate new demand for the stock. Successful interactions with both current and target investors are imperative for making sure there is market support for SpinCo's shares once they're spun off. Investor relations and management should develop SpinCo's equity story together to ensure harmonization and consistency.
- **Communication with shareholders—**As an independent, publicly traded company, SpinCo will need to communicate and interact with its shareholders regularly. That will include scheduled reporting of financial results and earnings calls as well as other communications that investors need to assess SpinCo. You'll need to:
  - Prepare summary financial information every quarter, ready to send to shareholders.
  - Prepare an annual report to send shareholders. It needs to include audited financial statements, a letter to stockholders from the CEO and/or the chair, and management's analysis and discussion of SpinCo's financial condition and the results of its operations.
  - Prepare an annual proxy statement to send to shareholders. It will cover matters like electing members of the board of directors and voting on stockholders' proposals.
  - Host an annual shareholders' meeting.

Both pre and post-spin-off, it's important to develop a strong relationship with the investors, Wall Street research analysts and the buy-side investors.

- **Interaction with the investor community, Wall Street analysts and the buyside—**Many CFOs say they spend at least 25% of their time talking to new and existing investors. The investor relations group will be able to coordinate these interactions. Your current holders would expect SpinCo to:
  - Continue to interact with SpinCo's top holders and potential buy-side investors through industry/banker conferences, non-deal roadshows and regular meetings.
  - Provide earnings guidance to Wall Street and research analysts.
  - Select and schedule industry/banker conferences including one-on-one meetings.
  - Schedule in-person company presentations for annual research analysts.

Conclusion

As you can see, if spinning off part of your company will help you create more value for investors, there's plenty to keep track of. But there's no need to start from scratch.

Take advantage of our experience. So you'll know what decisions you have to make, and when you need to make them. We can guide you on the road and point out dead ends and useful shortcuts thanks to our years of experience.

If you have any questions, we're here and waiting to hear from you.

For more information on delivering value on your divestiture, please contact:

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