RESTRUCTURING VIA SPINOFF: AN ANALYSIS OF THE ACCOUNTING RULES

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ABSTRACT

Spinoffs are a value-creating restructuring mechanism where divesture of assets results in a pro-rata distribution of shares in a newly formed company. We analyze two cases and a sample of 135 spinoffs to examine the impacts of spinoff accounting rules. We find that historical financial statements tend to bear little resemblance to the spinoff entity due to large debt-for-equity exchanges between parent and spinoff just prior to the offering. Since spinoffs often span more than one of the parent's business segments, constructing historical financials is a judgment-laden "forensic" process that results in significant costs and offering delays. Given the positive value implications of restructuring via spinoff, we propose changes to spinoff accounting rules that reduce historical statement requirements and improve proforma disclosure.

Keywords: Restructuring, Spinoffs, Accounting Policy, Divestitures, Covid-19.

INTRODUCTION

While creative disruption constantly pressures businesses to adapt and change, Covid-19 has arguably accelerated the need for rapid and significant restructuring of businesses to address the new economic conditions. A spinoff is a popular restructuring technique used by a parent company to divest. Securities and Exchange Commission (SEC) (2012, 2015, 2020) describes a spinoff as the creation of an independent firm through the distribution of new shares of existing businesses, divisions, or segments.

The academic literature shows that spinoffs create value. For example, Schipper & Smith (1983) document positive market reactions to spinoff announcements linked to expectations for *"improved managerial efficiency."* Cusatis et al. (1983) demonstrate the long-term positive performance of spinoff entities and argue that *"spinoffs provide a low-cost method of transferring control of corporate assets to bidders who will create greater value."*

Recent evidence also shows that parent firms that divest benefit from restructuring. EY (2020) finds that companies that divested during the global crisis of 2008-2010 significantly outperformed a matched sample of firms. A KPMG (2020) study shows that companies have more rapid *earnings growth following divestures and concludes that "*such transactions increase shareholder value."

For all filers with equity float greater than $75M *("large filers'*), SEC (2020) requires two years of historical balance sheets and three years of statements of comprehensive income for the spinoff entity. Since an historical statement of comprehensive income requires both a beginning and ending period, four years of historical balance sheets are required. Many spinoffs span more than one segment or division of the parent. Preparing historical financials thus requires defining parameters to separate the operations, revenues, and expenses of the spinoff entity. Thus, the *"historical financial information about the legal entity…is unlikely to be an*

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adequate representation of the economic activities of the carve-out business." (KPMG, 2020) The frequency of multiple-year transitional services agreements between the spinoff and parent also highlights the extensive co-mingling of operations prior to the spinoff.

SEC (2020) also requires one period of proforma financial statements for the spinoff entity. The proforma statements reflect adjustments to the historical statements to capture the effect of significant acquisitions, dispositions, reorganizations, unusual asset exchanges, debt restructuring, and other transactions contemplated for the spinoff entity. SEC (2020) indicates that "pro forma financial information is intended to provide users with information about the continuing impact of a transaction by showing how a specific transaction or group or transactions might have affected historical financial statements, illustrating the scope of the change in the registrant's financial position and result of operations."

SPINOFF CASE ANALYSIS – ABBVIE and CHEMOURS

On October 19, 2011, Abbott Laboratories announced its intent to separate into two public companies. The new entity (AbbVie) was not an existing business segment of Abbott but would be constituted from operations focused on research-based pharmaceuticals. Thus, to provide required historical information about AbbVie required Abbott to define the key areas of the AbbVie's pharmaceuticals portfolio, research and development therapeutic areas, and topline sales.

The initial filing for AbbVie occurred in June 2012. The basis for the AbbVie offering on January 2, 2013 was the historical December 31, 2011 information and the proforma data from September 30, 2012. During the 14 months from the initial announcement to the offering, the AbbVie file was amended and reissued eight times. The management discussion and analysis (MD&A) was updated in the second and third quarters of 2012 to meet filing requirements, despite no material changes to the to the AbbVie business (SEC, 2012).

Table 1 provides historical, proforma, and year one financial information for the spinoff of AbbVie by Abbott Laboratories (Panel A) and the spinoff of Chemours by Dupont (Panel B). Leverage is measured as the ratio of total assets/total liabilities.

Table 1
SPINOFF FINANCIAL STATEMENTS

Panel A		**(in thousands)**				
FULL PERIODS	**YEARS**	**TOTAL ASSETS**	**TOTAL LIABILITIES**	**SHAREHOLDERS EQUITY**	**NET INCOME**	**LEVERAGE**
-3	2009	$15,858			$4,636	
-2	2010	$21,135	$5,431	$15,703	$4,177	0.26
-1	2011	$19,657	$7,434	$12,224	$3,433	0.38
	Proforma	$25,948	$21,068	$4,880	$3,243	0.81
	2012	$27,008	$23,645	$3,363	$5,275	0.88
1	2013	$29,198	$24,706	$4,492	$4,128	0.85

Panel A of Table 1 provides historical, proforma, and year one AbbVie financials. Due to Abbott's conversion of its equity stake in AbbVie into third party debt, AbbVie's liabilities increase by 232.3% and its equity decreases by 63.3% from historical year minus one (2011) to year one (2013). Over that timeframe, AbbVie's leverage ratio (total liabilities/total assets) increases from 0.38 to 0.85.

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The AbbVie proforma reflects this conversion. Panel A of Table 1 shows that the difference between the proforma leverage of 0.81 and the year one leverage of 0.85 is only 4.9%. Thus, the proforma balance sheet resembles AbbVie's year one balance sheet to a much closer degree than any of the historical financial statements.

In October 2013, Dupont announced that it was planning to divest its *"performance chemicals"* business along with associated assets from other segments to form Chemours. As of the announcement date, former Chief Accounting Officer (CAO) Amy Trojanowski estimates that accounting teams had been working preparing the historical financials for nearly a year. DuPont filed its initial registration statement in December 2014 and the spinoff of Chemours to was completed on July 1, 2015 (SEC, 2015).

Panel B of Table 2 provides historical, proforma, and year one Chemours financials. Like AbbVie, Chemours shows a significant upward shock to liabilities and a decline in equity just prior to the offering that is reflected in the proforma but not the historical financials.

Table 2
SPINOFF FINANCIAL STATEMENTS (cont.)

Panel B		**(in thousands)**				
FULL PERIODS	**YEARS**	**TOTAL ASSETS**	**TOTAL LIABILITIES**	**SHAREHOLDERS EQUITY**	**NET INCOME**	**LEVERAGE**
-3	2009	$15,858			$4,636	
-2	2010	$21,135	$5,431	$15,703	$4,177	0.26
-1	2011	$19,657	$7,434	$12,224	$3,433	0.38
	Proforma	$25,948	$21,068	$4,880	$3,243	0.81
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In both AbbVie and Chemours, the year minus one historical financials form the basis for the proforma statement. But the requirement to show three years of comprehensive income requires the construction of an initial balance sheet that is five years before the offering. In both cases, the historical balance sheets bear little resemblance to those of the actual spinoff entities due to the debt-equity exchanges just prior to the offering. The significant upward shock to liabilities reflected in the proforma financials of both AbbVie and Chemours also results in higher interest expense, making historical income less relevant.

SAMPLE ANLYSIS

We begin by searching the SEC.gov website for required spinoff documentation (Form 10-12(b)) filed for listing on NYSE or NASDAQ between 2000 and 2014. From the initial sample of 434 firms, we remove the firms that: (1) did not obtain a ticker; (2) did not receive an effective letter for the Form 10-12(b) submission; (3) withdrew their submission or never amended their submission upon receiving comments, creating an effective withdrawal; or (4) filed incorrectly, not meeting the requirement of a spinoff.

The resulting sample of 135 spinoffs span a wide range of industry sectors. Services, banking, real estate, retail (wholesale), and pharmaceuticals are the most highly represented sectors, comprising 57% of the sample. We construct a control sample of non-spinoff firms matched to each spinoff based on revenue and two-digit standard industrial classification to act as a control for time, industry, and firm size factors.

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Table 3 shows the analysis of a sample of 135 spinoff firms over the period from 2000-2014 and a sample of matched firms. This table shows the median percentage change between the financial metrics in the pro- forma financial metrics versus those in the first full year after the spinoff (year one). Statistical significance between the distribution of spinoff and matched firm changes is measured using a Wilcoxon rank sum test. Two-tailed P scores are provided and asterisks ***, **, * indicate statistical significance at the 1%, 5%, and 10% levels.

Table 3

MEDIAN CHANGE IN HISTORICAL VS. YEAR ONE FINANCIAL METRICS: SPIN OFFS VERSUS MATCHED SAMPLE

Median Percentage Changs: Historical vs Year 1			
	SPINOFF SAMPLE	**MATCHED FIRMS**	**WILCOXON SIGNIFICANCE**
Total Assets	11.50%	14.20%	0.34
Total Liabilities	37.50%	12.50%	0.00****
Total Equity	-16.70%	11.60%	0.00***
Net Income	-17.50%	-5.60%	0.14
Total Liabilities/Assets	8.10%	0.90%	0.01***

Table 3 shows the median percentage changes in financials from historical year minus one to year one for both the spinoff and matched control samples. For the spinoff sample, the median percentage increase in liabilities is 37.5% versus 12.5% for the control group. The spinoff sample median percentage decrease in total equity is 16.7% versus a median increase of 11.6% for the control group. The median leverage ratio increase for the spinoff sample is 8.1% versus 0.9% for the control group. Wilcoxon ranked sum tests indicate the sample and peer distributions for these three balance sheet items are significantly different. The difference reflects the tendency for parents to exchange their equity stake for debt in spinoff entities, as the AbbVie and Chemours cases illustrate. No similar type of equity-to-debt balance sheet restructuring tends to occur in the matched group.

The median percentage decrease for the spinoff net income from year minus one to year is -17.5% compared to -5.6% for the peer group. While the spinoff and peer distributions are not statistically significant at normal levels (p-value of 0.14), this median difference in sample and peer income changes of 11.9% would be material in financial reporting context. The decline between year one and historical spinoff net income is associated with the increase in liabilities associated with the parent exchange of debt for equity and the associated upward shock in interest expense (Ernst & Young, 2020).

Table 4 shows the analysis of a sample of 135 spinoff firms over the period from 2000-2014 and a sample of matched firms. This table shows the median percentage change between the financial metrics in the pro- forma financial metrics versus those in the first full year after the spinoff (year one). Statistical significance between the distribution of spinoff and matched firm changes is measured using a Wilcoxon rank sum test. Two-tailed P scores are provided and asterisks ***, **, * indicate statistical significance at the 1%, 5%, and 10% levels.

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Table 4 MEDIAN CHANGE IN PROFORMA VS. YEAR ONE FINANCIAL METRICS: SPIN OFFS VERSUS MATCHED SAMPLE			
Median Percentage Changs: Proforma vs Year 1			
	SPINOFF SAMPLE	**MATCHED FIRMS**	**WILCOXON SIGNIFICANCE**
Total Assets	10.30%	14.20%	0.86
Total Liabilities	10.00%	12.50%	0.99
Total Equity	5.00%	11.60%	0.37
Net Income	-3.30%	-5.60%	0.18
Total Liabilities/Assets	-0.10%	0.90%	0.38

Table 4 shows the distributions of percentage changes between proforma and year one financials for the spinoff and control group. The distributions of changes in liabilities, equity, and leverage ratio are not statistically significant, in contrast to Table 3. Details from the Chemours spinoff provide insight on why and how the proforma results differ from the historical. Per the Chemours 10-12B/A filing the proforma include: (1) $4.0B of Chemours debt at an expected weighted average interest rate of 5.75%; (2) the dividend, net of debt issuance costs and original issue discount, of approximately $3.9B to DuPont, consisting of a cash distribution of approximately $3.4B and a distribution in-kind of notes with an aggregate principal amount of $507 million; (3) the pro-rata distribution of approximately 181 million shares of Chemours common stock to DuPont stockholders; (4) the establishment of the cash and cash equivalents reference level of $200 million, as defined in the Separation Agreement; (5) transfers of assets and liabilities from defined benefit and other post retirement plans; and (6) impacts of various agreements between Dupont and Chemours (SEC, 2015).

Changes to both capital structure and operations can lead to significant net income volatility from spinoff proforma to year one. For example, AbbVie year one net income is 27.3% higher than proforma while Chemours is 97.5% lower. For the spinoff sample, the percentage changes between proforma and year one net income at the first and third quartile of the distribution are -109.7% and 53.7%, respectively. This volatility highlights the complexity of spinoff transactions, and the need for improved income related disclosures in proforma financials. Examples of these income-related spinoff specific issues include agreements between parent and spinoff regarding employee matters, the provision for and costs of transitional services, agreements about finished goods, supplies, and contract manufacturing, allocation of depreciation and amortization for assets that transfer at the spinoff date, and adjustments for lease agreements.

Spinoff proforma financial statements also do not reflect costs of operating as a stand-alone company, including higher information technology, tax, accounting, treasury, legal and other similar expenses. Only costs management has determined to be factually supported and recurring are included as proforma adjustments. In the Chemours case, subject to the terms of the Separation Agreement, all costs and expenses related to ongoing support of a stand-alone company, including certain one-time separation costs incurred after the distribution date, were the responsibility of Chemours. None of these costs were included in the proforma estimates.

Choi (2020) finds a negative association between prospectus tone and insider trading patterns in a study of spinoffs and argues that negative tone is used by managers to *"disguise upside potential"* of the spinoff. Given the complexity of spinoff transactions and extreme volatility between proforma and year one net income illustrated in both the sample and the AbbVie and Chemours cases, increasing the requirements for detailed proforma disclosures

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regarding income-related items can improve transparency and help to reduce the impact of tone-related disguises.

COST AND TIME TO CREATE FINANCIAL STATEMENTS FOR SPINOFFS

Since spinoff entities are typically not a single stand-alone business segment, constructing multiple years of historical statements requires a great deal of judgment as to what would have been *"inside"* the entity in historical periods. To compound the challenge, obtaining the information required to produce historical statements often requires access to both active and inactive accounting systems. Thus, creating historical financial statements for spinoffs is often more of a *"forensic"* activity due to the change in people, processes, and systems.

The requirements to produce both historical and update proforma financial information quarterly lead to significant costs and delays in spinoff initial public offerings. In the case of Chemours, former CAO Amy Trojanowski estimates that each historical year of data delayed the offering by an average of six months. Time and costs were driven by the need to establish methodology, gather available data, perform a detailed review of transactions, and engage in forensic exercises necessitated by business changes, reporting unit changes, and turnover of personnel. Relying on a team of 150 people, Ms. Trojanowski estimated total expenditures of $100M and a period of between of 30-36 months to meet financial statement requirements necessary for the Chemours spinoff from Dupont.

RECOMMENDATIONS

Based on the detailed analysis of two cases and a sample of 135 spinoffs, we recommend that only one year of an historical statement of comprehensive income and balance sheet be required as the foundation for the proforma financials for large filers. The reduction from three to one year of comprehensive income reduces the number of required historical balance sheets from four to two. Based on the Chemours experience, each historical balance sheet takes roughly six months to construct. Thus, this change this would allow spinoff entities to access markets approximately a year earlier and at much lower cost.

Due to the significant operational changes and net income volatility associated with spinoff launch, we recommend that proforma disclosure be enhanced to include descriptions of changes to capital structure, enhanced discussions of stand-alone operational cost considerations, material employee matters, transitional service arrangements, manufacturing agreements, and asset transitions inclusive of depreciation and amortization, and leasing arrangements.

Lastly, we recommend removing the requirement to update MD&A quarterly after the initial filing unless there has been a material change in the business. In the case of AbbVie, this requirement led to two quarterly filings in 2012 that discussed historical financials, which failed to provide useful financial information on significant transactions just prior to the offering.

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