

# Divestiture as a New Trend in the Information Age

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## ABSTRACT

*The world has seen so many companies merging in their pursue of becoming the greatest in every sector of industries. Some of them have survived, and some have not. Most of the survived ones have undergone the opposite way of merging; called divestiture. Due to some factors such as financial, managerial and operational, these companies have split-off the 'added-up' part of them and focus on their core businesses. Realize it or not, this trend has been followed by some Malaysian companies in the era after the economic turmoil in 1997 such as Telekom Malaysia (TM) and Land and General (L&G). This paper discusses the types of divestiture as well as the reasons for divestiture.*

**Keywords:** *Divestiture, Spin-off, Split-off, Sell-off*

## Introduction

The word divestiture may not be as popular as the word merger or acquisition since there is only a few definitions mentioned in the accounting textbooks. As the word merger or acquisition refers to the combination of independent business units into single entity, divestiture is the other way around. John and Tina (1999) states that divestiture involved separating various units of a company into independent units, or even disposing off any subsidiary by a parent company to a third party. In

short, divestiture is described as a disposal of a division or controlling interest in any subsidiary company.

Khan and Mehta (1996) defined divestiture as a reduction in the firm's operational asset base. The firm's operational assets here refer to any divisions of a company or any subsidiaries or associates of a holding company. Thus, previous researches on divestitures have been focusing on stockholder wealth effects of such a restructuring process.

## **Divestiture as a New Trend**

According to John and Tina (1999), during the 1980s, diversification was the driving force behind many corporate acquisitions in the United States. To maximize shareholders' value, corporations diversified risk by expanding beyond their core business into other industries. This has been a trend followed by the rest of the world, where companies were going bigger and bigger by means of mergers and acquisitions. However, according to Paul (2002), the idea that bigger is automatically better began to wane a decade ago. It is then bigger is not always better.

John and Tina (1999) stated that, as the '80s were known as the decade of mergers and acquisitions, surely the '90s will be known as the decade of divestiture. This is through the fact that more and more companies were going back into their core business rather than diversification in those developed countries. However, as in Malaysia, it happened 10 years later, few years after the economic downturn which was due to devaluation of Ringgit Malaysia in 1997.

In late 2001, we saw Telekom Malaysia (TM), a huge telecommunication company in Malaysia made a drastic restructuring plan to divest most of its departments as well as rearranging its subsidiaries such as TM Net and TM Touch. Another big and diversified company in Malaysia since 1990s, Land and General (L&G), followed similar action by selling off most of its subsidiaries trying to focus on its main business; property development.

According to Paul (1999), from 1988 to 1998 there were over 300 companies in the United States have been into such restructuring. Over the years, the world has seen giant conglomerates such as Campbell, PepsiCo, Westinghouse, Cognizant and many more went into such restructuring. Thus, we can see a new trend is coming into the corporate world, leaving the old restructuring methods away.

## **The Driving Forces**

Most of the companies going divested, according to Patricia, Steven and Somu (1999), have one goal in their mind; creating value for shareholders. Empirical evidence in the form both Price-to-Earnings (P/E) multiples and Total Return to Shareholders (TRS), the combined capital appreciation and dividend yield of an equity demonstrates that, on average, each form of restructuring creates value.

Gains in stock price, stated by Patricia et al. (1999), flow from four changes. Firstly, there is an increase in coverage by analysts. This seems to support investment banker's claims that floating equity in business units not previously exposed to the market makes their operating performance more transparent and raises shareholder returns by revealing hidden value. Secondly, the restructured subsidiaries attract new investors. Thirdly, the restructuring of ownership usually improves a subsidiary's operating performance through such means as new incentives to management. Finally, restructuring can improve corporate governance and increase strategic flexibility.

In addition, Khan and Mehta (1996) have identified that such a divestiture of a division may occur when the division's operations are no longer profitable, or the division still able to cover its unique operational costs, but fails to cover the overhead burden, or if it still able to cover the overhead burden, it fails to provide the required return, or finally, if still provides the required return, changes in the environment make its divestiture more attractive through improving the overall efficiency of the firm.

From here, we can see that the general idea behind any divestiture plan is to increase shareholders' wealth by creating shareholders' value. This possibly is seen as result of improved divisional performance through positive competition among themselves.

Cusatis, Miles and Woolridge (1993) have come out with evidence that a strategy of investing in either parent companies that undertake spin-offs (a method of divestiture) of subsidiaries or the spun-off subsidiaries themselves provides superior investment performance. Thus, it is the idea that a strategy of buying spun-off entities once they begin trading as independent stock provides a route to superior portfolio performance.

However, a study done by Roni and Wayne (1995) provides little support for the argument that divestitures result in increased operating efficiency. When they compare the pro-forma results filed at the time of

the offerings to those filed a year after the transaction, they found a significant deterioration in the return on assets of both spun-off companies and sold-off companies. Thus, the expectation of future operating benefits may not be a good reason for corporate divestiture.

The fact is that, most companies going for divestiture for one main reason; the need to focus on core competencies (John and Tina, 1999). An example of this can be seen in the Quaker Oats Company. In 1980s, Quaker owned Brookstone Company and Fisher Price Toys as well as its cereal and beverage businesses. In 1987 Quaker divested Brookstone and in 1991 completed the divestiture of Fisher Price Toys. Quaker Oats Company today is more streamlined and focused company than it was a decade ago.

Telekom Malaysia, as claimed by its restructuring committee, needs to focus on its core business, of providing fixed line and data services. Thus, it needs to somehow privatize all its supporting divisions such as Property Management, Fleet Management as well as Securities and independently operate within TM group of companies. Performance evaluation is another force for such restructuring. According to its restructuring committee, for these years, these departments have been miss-evaluated since they were not revenue nor profit centers for the company. As such, evaluations were worthless and they were just seen as big spenders to TM even though they have contributed a lot in its development until today.

Another reason, cited by Paul (2002) is meant for debt relief. In the past, companies have used spin-offs not just to get rid of unwanted businesses but also to unload debt. An example for this is Marriott Corporation. In 1993, Marriott Corp. split-off its real estate business into a separate company, which assumed more than \$2 billion of Marriott's debt.

In short, the high operational cost of divisions, the forces to focus on core competencies and relieving from debt obligation are among the famous reasons for divestiture. Though there may be a number of reasons for divestiture, the primary goal is probably to maximize shareholders' value.

## **Forms of Divestiture**

Previous researches have shown various forms of corporate divestitures. Roni and Wayne (1995) have come out with two sets of divestiture, namely; spin-off and carve-out. Spin-off here refers to the separation of

business divisions without selling it to new shareholders, while carve out refers to the selling off to a new set of shareholders. They have identified three differences between these two types of divestitures. First, shares in a spin-off are distributed to existing shareholders; a carve-out establishes a new set of shareholders. Second, stocks issued through a carve-out generate positive cash flow to the firm, while spin-off does not have immediate cash flow consequence. Third, firms that divest through carve-out incur significantly greater out-of-pocket expenses and are subject to more stringent disclosure requirements by the Securities Exchange Commissions (SEC).

Similarly, Edward, Lee and Ray (1998) stated that, a spin-off involves the pro rata distribution of a controlled corporation's stock to the distributing corporation's shareholders without their surrendering any distributing corporation's stock. Adding to this, they found that the popularity of this method of divestiture, especially when the alternative is a simple divestiture, can be traced to a company's ability to structure the transaction so it is tax-free.

Khan and Mehta (1996) meanwhile, have identified two forms of a voluntary divestiture, which is the outcome of deliberate decision made by the management of the divesting firm, and not being forced by external parties. They are sell-off and spin-off. Sell-off requires relinquishing both ownership and control in the divested unit, while a spin-off involves creating a new corporation whose shares are distributed to the existing shareholders with the control shifting to a new management team. This definition of divestiture method seems quite similar to what has been suggested by Roni and Wayne (1995). Only here, the term sell-off used by Roni has been substituted with carve out by Khan.

Accounting textbooks however, do not cover much about divestiture, as compared to business combinations. A textbook by Pahler and Mori (1997) just defines a split-off as part of its discussion of the "change in equity interest" criterion related to a pooling of interest as follows: "The spin-off of a subsidiary of division to certain existing shareholders in exchange for some or all of their common stock is an example of a distribution and retirement of outstanding securities".

The other advance financial accounting textbook by Huefner et. al. (1999) discusses sell-offs and spin-offs as ways of restructuring and refocusing a diversified corporation. However, none of these textbooks discusses in depth about these forms of divestiture, neither being taught in detail in schools.

The forms of divestiture drawn by John and Tina (1999) would be the most understandable to differentiate between forms of divestitures. They have divided into four forms of corporate divestiture, they are; **Sell-off** by exchanging the division's assets or subsidiary's stock for assets or in settlement of debt; **Spin-off** by distributing the subsidiary's stock pro rata to the parent company's shareholders as a dividend; **Split-off** by distributing the subsidiary's stock to the parent company's shareholders in exchange for shares of the parent's stock, and **Split-up** by distributing the stock of two or more subsidiary companies to the parent company's shareholders in exchange for all the parent's stock, followed by the liquidation of the parent company.

A sale of a division or subsidiary to a third party for cash or other assets or through initial public offering is the most common form of divestiture. Usually, companies sell under-performing segments to reallocate resources to higher-valued uses, as mentioned by Ravenscraft and Scherer (1991). For instance, in moving to concentrate on core businesses, this has been observed happening to PepsiCo and Quaker Oates Company.

Another reason, mentioned by John and Tina (1999), is if the parent company is experiencing financial difficulties and needs resources, but has exhausted debt or equity sources, selling a division or subsidiary may be its only resource option.

On the other hand, most often, companies spin-off a presumed undervalued segment to increase the combined market valuation of the parent company and separately traded former subsidiary company, as stated by Aron (1991).

A good example for this, according to Aron (1991), is Lennar Corporation, where in effort to boost the perceived value of its real-estate business, it spins-off its commercial real-estate business into a separate publicly traded company, which were then called LPC Inc.

However, findings by Roni and Wayne (1995), Pagano et. al. (1994) and Zingales (1995) show that the decision to sell-off divisions may be motivated by control consideration, rather than a need for cash. It was found that the cash flow level of the parent company gone for selling-off its divisions does not seem unusually low prior to the divestiture, and their return on assets does not significantly improved in the years after the transaction.

The reasons for a spin-off are firstly, to shift investment portfolio decisions from the distributing company to its shareholders when the spun-off subsidiary's industry is subjected to excessive operating volatility

(Ball 1997 and Cusatis et al. 1993). Secondly, to unleash the entrepreneurial drive of the spun-off subsidiary's top-level management (Garton and Heaney 1995). Thirdly, to improve the link between divisional management compensation and divisional productivity (Aron 1991 and Ball 1997) and fourthly, to improve operating performance of both the distributing company and the spun-off subsidiary from reduced agency and overhead costs, sharpened focus and market, as opposed to administrative capital allocation (Ball 1997 and Cusatis et al. 1993).

In addition, Roni and Wayne (1995) reveal that riskier, more leveraged, less profitable firms choose to divest through spin-off. The result also shows that the spin-off parents are more highly leveraged and much smaller in size.

A split off is viewed by the distributing company as a repurchase of its outstanding common shares or acquisition of treasury shares by transferring control over a subsidiary directly to the distributing company's shareholders. An example for split-off is Cooper Industries, Inc. Shareholders are offered to exchange shares of Cooper common stock for shares of common stock of Cooper Cameron Corporation, the new company that was established for the split-off of Cooper's Petroleum and industrial equipment business.

A split-up, instead, may involve transfer of property from a parent company to its existing or newly created subsidiary companies and then liquidation of the parent company through a distribution of the subsidiary companies' stock to the parent shareholders in exchange for all its stock.

Cognizant Corporation, an example for a split-up reported by the Wall Street Journal (January 15, 1998, A3) that "the crown jewel created by the three-way break-up of Dun & Bradstreet Corporation (1996), is itself splitting up." It is also reported that "the company believes the businesses will be better off separate because they have different customers and opportunities". That has led the company to split-up into separately traded company that focus on their core businesses.

## **Regulatory Requirements Pertaining to Each Form of Divestitures**

### **Sell-Off**

As it is defined by Accounting Principles Board (APB) Opinion No. 30 (APB 1973b), the company must estimate the gain or loss from a sell-

off on the date (called the measurement date) that management approves a formal plan to dispose of the division or subsidiary. It also requires that the company report, on a net-of-tax basis, any realized gain or loss or estimated loss from disposal of a discontinued segment and the operating income or loss from that discontinued segment separately from the income from continuing operations on the current period income statement and all prior period income statements that are presented for corporate purposes. Subsequent changes in an estimated loss from such disposals must be reported in a like manner in that year's income statement.

In addition, the company must disclose the discontinued segment's entity, the expected date and manner of the disposal, the discontinued segment's net assets and liabilities at the balance sheet date and the income or loss from operations and any proceeds from the disposal from the measurement date to the balance sheet date.

## **Spin-Off**

APB Opinion No. 29, paragraph 23 states that:

*“Accounting for the distribution of non-monetary assets to owners of an enterprise in a spin-off or other form of reorganization or liquidation or in a plan that is in substance the rescission or a prior business combination should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the monetary assets distributed”.*

Paragraph 23 also discusses other methods equivalent a spin-off. It states that:

*“A pro rata distribution to owners of an enterprise of shares of a subsidiary or other investee company that has been or is being consolidated or that has been or being accounted for under the equity method is to be considered the equivalent of a spin-off. Other non-reciprocal transfers of non-monetary assets distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.”*

Emerging Issues Task Force (EITF) Issue No. 87-17 (FASB EITF 1987), however, requires a spin-off of a non-operating subsidiary to be accounted for as a dividend-in-kind at fair value rather than a spin-off at book value.

## **Split-Off and Split-Up**

Paragraph 23 of APB Opinion No. 29 cited, a pro rata split-off should be accounted for at book value, whereas EITF Issue No. 96-4 (FASB EITF 1996) states that a non-pro rata split-off of a segment of a business in a corporate plan of reorganization should be accounted for at fair value. Similarly, EITF Issue No. 96-4 states, “that a split-off of a targeted business, distributed on a pro rata basis to holders of the related targeted stock, should be accounted for at historical cost”.

A company should recognize no gain or loss (other than a loss of any indicated impairment in value) from a pro rata split-off/up and from a split-off/up that is in substance a recession of a prior business combination. Alternatively, in a non-pro rata split-off/up or a pro-rata split-off of targeted stock created in contemplation of a subsequent split-off, the distributing company should recognize a gain or loss for the difference between fair value and book value.

## **Conclusion**

As we are moving into the so-called information age, the world of corporate seems to be moving alongside by being focused on core competencies as well as cost minimization. The trend of going smaller (divestiture), although not as popular as going bigger (merger and acquisition), is another strategy in corporate world today.

Several motivating factors have been discovered for this type of restructuring by previous researchers. They are summarized as; creating shareholders value; positive market reaction; problems in divisions financing; focus on core competency and, debt relief.

On the other hand, other companies may divest their divisions for the purpose of cost effectiveness or the need for concentration on product developments. Thus, they may want to spin-off their divisions, so that, they can focus on their core business. Either way, the primary purpose of divesting divisions or subsidiaries is to increase shareholders' value.

The reason for divestiture meanwhile, plays an important role in identifying the most appropriate type of divestiture plan. One may choose to divest by ways of spin-off, sell-off, split-off or even split-up depending on its motive of restructuring. As for example, company with critical financial difficulties may sell-off its divisions so as to generate cash, and thus, redevelop.

Finally, it is obvious that in the corporate world, everything is possible, whether to grow bigger for the sake of gaining a prestigious name as it may seem, or oppositely, shrink for the purpose of getting into control of main operation. If it is not viable anymore to be a giant company in this recovering economy, then, it would be best to be focused and in control of every aspect of operation. It is just a corporate strategy in a corporate race.

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*Telekom Malaysia Change Programme Newsletter*, (internal publication), Telekom Malaysia, Issue 1-9/2001. [http://www.telekom.com.my/telekomhtml/corporate/news\\_archieve.php](http://www.telekom.com.my/telekomhtml/corporate/news_archieve.php)