Interim operating models:
CFO guidelines to drive through complexities

Interim operating models

Are you the CFO of an entity spinning off, where not all the legal entities will be transferring over? Or are you on the buy side and realize that the asset you are purchasing will not have the necessary authorizations and infrastructure to conduct business within your program timeline?

Interim operating models (IOMs) are designed to address these complexities and accelerate the sign to close process while maximizing value.

IOMs detail how specific legal entities transact with customers and other legal entities including sellers and buyers after principal close of a merger and acquisition (M&A) transaction. Depending on business cross functional (e.g., tax, legal, HR, IT), regulatory, and strategic considerations, there are a myriad of possibilities to set up these arrangements to govern specific geographies.

In figure 1, we present a list of the most common interim operating model archetypes and their main characteristics as they relate to customers, people, and financials.

Regardless of the interim operating model archetype, finance leaders should be prepared to navigate through business complexities. This white paper aims to discuss main areas of concern and provide a high level perspective on how most efficiently to approach them.

Figure 1. Common interim operating model archetypes and characteristics

	Disclosed agency	Undisclosed agency	Distributor	Net economic benefit (NEB)
Description	The principal (Buyer) appoints an agent (Seller) to act in its name and on its behalf—the structure is disclosed to relevant third parties	The principal (Buyer) appoints an agent (Seller) to act in its own name but on principal's behalf—the structure is not disclosed to relevant third parties	The Buyer appoints the Seller as its distributor post-close	Seller continues to own and run the business locally and pays the Buyer the net profit (or collects loss)
Distinguishing characteristic	Orders/invoicing are transacted by the Seller, as a disclosed agent, for the benefit of the Buyer. Invoices to state 'issued in the name and on behalf of principal.'	Orders/invoicing are transacted by the Seller, as an undisclosed agent; considered to be a 'deemed buy-sell' transaction	The Seller provides distribution services for the Buyer	The Seller continues to operate the business on behalf of the Buyer, providing net economic benefit to the Buyer
Customers	Buyer	Buyer, but not disclosed to customers and authorities.	Buyer	Seller
Revenue recognition	Typically Buyer	Typically Buyer	Typically Buyer; the distribution agreement establishes terms	Varies based on the terms of the agreement
Potential fees	Agency fee (typically issued separately as a services invoice by the Seller)	Agency fee (commonly embedded in the 'deemed buy-sell' transaction between principal, undisclosed agent, and end customers)	Distribution fee (may be issued separately as a services invoice by the Seller or may be subsumed in buy-sell of product)	NEB services (commonly issued separately as a services invoice by the Buyer)
Inventory ownership	Buyer	Buyer	Buyer	Seller

For a comprehensive introduction on interim operating models, please refer to Deloitte's "Introduction to divestiture strategy and operating models" *analysis.*

Interim operating model complexities

Content summary

- **Governance structure**
- **Segmentation of data**
- **Local regulations**
- **Revenue recognition** *+ accounting treatment*
- **Cash management and settlement**
- **VAT** *+ financial flows*

Governance structure

Development of interim operating models is a highly interdependent process with significant complexities across the business. Without the right team of leaders, progress will be limited as more complexities are revealed. As a result, it is imperative that leaders are involved from the beginning and the appropriate cadence of interactions is enabled.

The team required to build operating models is generally made up of leaders from finance, accounting, tax, operations/supply chain, commercial, regulatory affairs, global trade, legal, and IT.

In most engagements, the team required to define and support IOMs consists of:

- The Project Management Office (PMO), which provides overall strategic direction in the process.
- Key functions (accounting, tax, treasury, regulatory affairs, supply chain, IT, and legal) responsible for designing operating model solutions and developing milestones for implementation (figure 2).

A strong feedback loop and escalation from key functions to the PMO will ensure risks and issues can be effectively mitigated early.

Figure 2. Functional level of engagement per interim operating model

	SUPPORT LEVEL		
KEY FUNCTIONS	**Agency**	**Distributor**	**Net economic benefit**
Finance & accounting	▲ High	▲ High	▲ High
Tax	▲ High	▲ High	▲ High
Treasury	◆ Medium	▼ Low	▼ Low
Legal	◆ Medium	◆ Medium	◆ Medium
Regulatory affairs	◆ Medium	◆ Medium	▼ Low
Information technology	◆ Medium	▼ Low	▼ Low
Supply chain	▼ Low	▼ Low	▼ Low
Commercial	▲ High	◆ Medium	▼ Low

Segmentation of data

Designing interim operating models without considering data segmentation requirements and impacts can result in significant downstream challenges during execution. During the interim operating model period, there is typically a marked uptick in the need to segment transactions and data, which can result in a series of ad hoc or reactionary measures taken across business processes and systems by various finance, tax, accounting, and operational teams. Taking a holistic approach to identify and apply a combination of data segmentation and access control mechanisms will best serve the near-term needs of the interim operating model, while enabling preparedness for any potentially imminent transaction.

There are a variety of data segmentation-enabling measures that can be adopted within the interim operating model, ranging from introduction of codes or custom dimensions to tag and segregate records, to the application of logical separation and access-based controls, driven by a combination of data record ownership and user role in the interim operating model.

In the case of financial systems such as accounts payable applications, segregated company codes and product codes can be employed to distinguish and segregate requisition data, including purchase orders for goods and services. In enterprise resource planning (ERP) systems, new or transitioned financial business units may be introduced as new legal entities become available in the interim operating model. Additionally, replication of permissions may be necessary in the interim period to extend existing requisition workflow approver data to apply to new business units until transitioned to the final management reporting structure. This is often done to ensure that multidirectional support for segregated financial transaction data is possible until the target state is achieved. Another mechanism that may be leveraged for systems servicing balance sheet accounting, reconciliation, and certification is the deployment of segmented user access concurrently with separated account groupings by the various business units in the interim operating model.

Tagging can also be an effective means of achieving segregation, where, for example, invoice processing data can be coded with custom fields or dimensions to segment data. In support of certain treasury functions in the interim operating model, segmentation of banking transaction data can be enabled through replication of company codes in ERP systems for payment processing. Standing up new corporate ledgers also enables the segmentation of general ledger postings, journal entries, and other financial transactions. At a more technical level, activating row-level security controls for back-end databases of key financial systems, including ERP and close and consolidation applications, can help restrict access to the appropriate segmented financial reporting datasets by users and service accounts.

Finally, other enterprise environments such as SharePoint, Teams, and file shares that may contain department-level or financial data must be segmented with the appropriate user access controls in place.

In line with best practices, it is also prudent to take into consideration available solutions to clone or segregate historical and archived data while planning for the target state.

Local regulations

Interim operating models are inherently complex and may be governed by specific regulations that vary from country to country. Local tax, finance, and compliance regulations should be carefully considered and planned for when defining the appropriate model to implement per market. Each jurisdiction will have its own definitions, registrations, and filing requirements governing what is possible. For example, while an undisclosed agency model may be acceptable in Country X, Country Y may not recognize the model—or it may have its own naming convention and operationalization requirements.

When defining an interim operating model, it is imperative to first understand the tax consequences for the business and plan for the regulatory process and registrations that will be required—including direct and indirect taxes. Moreover, the organization must be aware of what financial documentation it will be required to provide as part of the local regulatory process, which may include financial forecasts, audited financial statements, and other corporate documents.

Further, the business needs to understand financial filing requirements, formats, cadence, and overall capabilities required to comply with local regulations.

The business must plan for the resources and overall capabilities (e.g., invoicing systems) that it will require to implement and support the interim operating model.

Finally, regulatory aspects of interim operating models should be part of a proactive regulatory requirements management program to enable regulatory compliance, reduce risk of enforcement actions, and increase speed to market.

Figure 3 compares the relative complexity of interim operating models. The NEB model presents the lowest regulatory complexity, as the seller continues running the local business and only passes the NEB to the buyer, usually at a global level. An undisclosed agency model requires the buyer to have a local presence; however, the regulatory process is somewhat simplified in that the buyer does not need to disclose its status in the market. As an example, in the undisclosed agency model, the seller may continue to invoice customers with no mention of the buyer. In contrast, both in distributor and disclosed agency models, the buyer's status in the market is known to relevant authorities and customers, which may increase the regulatory requirements for the buyer.

(For key changes to life sciences regulations, please refer to Deloitte's global report, *Never the same again: How COVID-19 created seismic change in life sciences regulations*).

Figure 3. Interim operating model relative complexity of local regulatory requirements

Revenue recognition (and accounting treatment)

The sales and distribution model employed during the interim operating model period is of paramount importance, as these decisions have significant impacts for finance, tax, IT, and supply chain operations. The form and substance of the model, based on the agreement entered into by the parties, will have a direct result on the accounting for the activities during the IOM period, specifically the impact on revenue recognition for the sale of products. There are a number of considerations in assessing the revenue recognition impact including which party controls the product prior to its sale and whether an entity is acting as a principal or as an agent in the transitions.

AGENCY MODEL (disclosed or undisclosed). The seller (agent) is engaged by the buyer (principal) to continue to fulfill customer orders and typically pays an agency that is based on a percentage of revenue. The undisclosed agency model provides limited disruption for the order-to-cash process, whereas the disclosed agency model requires the seller to update its systems (including customer invoices, shipping documents, etc.) to reflect its involvement as an agent. The disclosed agency model is more widely used, and certain jurisdictions do not permit the use of the undisclosed agency model.

The buyer typically recognizes gross revenue and expenses under the agency model as it is the party that controls the inventory prior to sale to the customer and is responsible for the goods or services delivered to the customer. The seller (agent) does not assume control of the goods or services before they are transferred to the customer and records the transactions net, only any fee paid to it by the buyer for its services as an agent, and any value-added tax (VAT) obligations that it retains.

DISTRIBUTOR MODEL. In markets where an agency model is not permitted, or where the cost of the service is disproportionately high compared to the size of the business, the buyer might appoint the seller as its **distributor**, and the buyer retains the right to the sales/profits in the market via a distribution agreement. The revenue recognition accounting for this type of operating model is dependent on whether there is a risk of loss and control transfer to the seller (distributor) under the distribution agreement.

a. Risk of loss and control **do not transfer to the seller**: The buyer records revenue recognition at the time of sale to a third party at the full invoice value and records separately any distribution fee paid to the seller and the assets and liabilities related to the sale transfer to buyer, except VAT that must be retained by the legal party to the invoices. The buyer will typically transfer title of the goods to the seller prior to its distribution to the customer, through a sale to the seller. The buyer will need to identify any inventory it has sold to the seller at the end of each reporting period that has not been sold onward to a third party so that such sales are eliminated (similar to intercompany sales) and similarly will need to record the incremental sales (from seller to customer), if any, at the time of the sale to the third party. This requires information from the seller that should be agreed to as part of the operating model agreement.

b. Risk of loss and control **transfer on sale to the seller**: The buyer records revenue recognition at the time of sale to the seller and does not record revenue for the difference between this value and the sale price to the third-party customer. The remaining profit transfer will be recorded on a "net basis" as profit. This results in a reduction of the top-line sales during the period of the operating model agreement.

The form and substance of the model, based on the agreement entered into by the parties, will have a direct result on the accounting for the activities during the IOM period, specifically the impact on revenue recognition for the sale of products.

It is important to note that the following scenarios are focused on US GAAP considerations—there may be differences in accounting treatments under local GAAP.

NET ECONOMIC BENEFIT (NEB). Unlike the distribution model or the agency model, under the NEB model the seller still owns the business in the local market until full separation in the market. The seller continues to operate the business in the local jurisdiction(s) as is and pays the buyer globally (in an agreed jurisdiction) the net profits of the local operations on a periodic basis. The initial transactions will be recorded and recognized by the seller, and the seller will report the operating activity to regulators (e.g., tax returns, statutory financial statements, etc.).

The accounting for the operating activity under US GAAP is dependent on the terms of the agreement between the buyer and seller.

The overall M&A transaction agreement will typically transfer the risk and rewards of ownership, and all associated economic benefits/costs, to the buyer for the entire acquired business even if the business has not transferred in the local market. This results in a situation where the seller, in agreement with the buyer, is operating the business on behalf of the buyer.

Similar to the other models, the revenue recognition accounting treatment is dependent on whether there is a risk of loss and control transfer to the seller under the NEB agreement even though legal title is retained in the local market by the seller. This assessment requires the parties to consider the agreement and the various rights and obligations including, but not limited to:

- Which party is responsible for fulfilling the promise to provide the good or service and is responsible for meeting the customers' requirements.
- Which party has inventory risk before or after the sale (e.g., which party is responsible for any returns).
- Which party has discretion in setting the price to the customer.

Under the NEB model, this assessment is not simply based on the legal sales to the customer.

For example, while the seller may transact with the customer and will accept any returns and provide refunds or replacement products to the customer, the profit transferred to the buyer is typically reduced by the impact of any returns, and the buyer often indemnifies the seller from any loss associated with operating the business on its behalf.

The ultimate accounting treatment is dependent on this assessment as follows:

a. Risk of loss and control **transfer to the buyer**: The risk of loss associated with the operations being conducted on behalf of the buyer are transferred via the NEB agreement. This results in consolidation of assets, liabilities, and results of operations from the business by the buyer and the recognition of all activity by the seller (except as prohibited, such as VAT).
b. Risk of loss and control **do not transfer to the buyer**: The risk of loss, based on the calculation of the NEB profit, transfers to the buyer under the NEB agreement. If control of the assets and business do not transfer, the buyer only recognizes the profit under the NEB agreement, and the seller continues to reflect the assets, liabilities, and operations associated with these operations in its financial statements.

Under this model it is essential that the parties agree on how the agreement will be operated upon entering into the operating model. This includes, but is not limited to, the rights of each party (such as setting prices, customer negotiations, etc.), how the NEB profit will be calculated, the frequency and timing of the cash settlement and any "true-up," or at the end of the NEB model.

As the seller is continuing to operate the business locally and the profits are paid to the buyer in a different market, there may also be tax implications that should be considered.

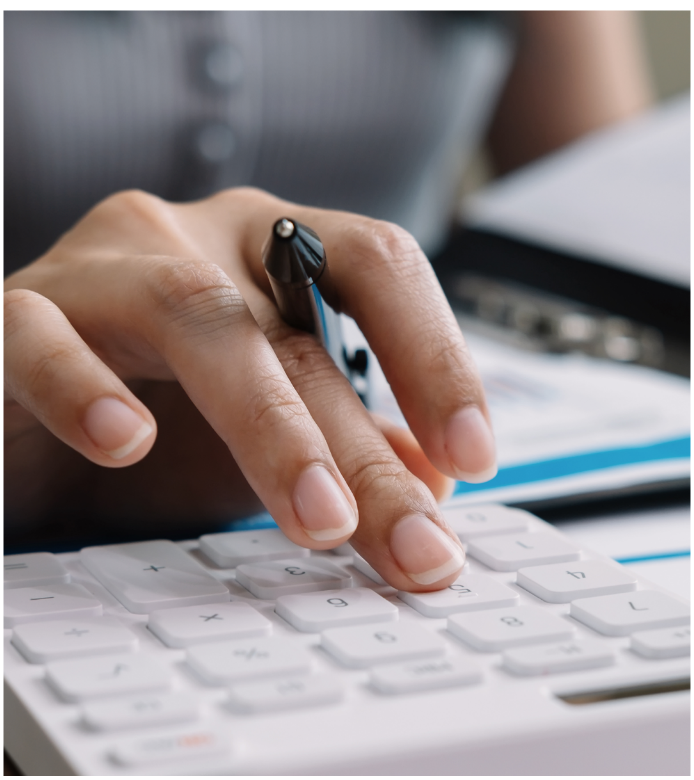
This model typically is used where there are regulatory reasons a local market cannot close at the time of the global M&A transaction, or the buyer does not have the IT systems to operate the business. The advantage of this model is that the seller has operational expertise and know-how in that market, where the buyer potentially lacks the expertise and infrastructure to operate efficiently.

Cash management and settlement

An M&A transaction, specifically a complex global transaction, often requires the parties to enter a variety of agreements including agreements to transfer assets, liabilities, revenues, operating model agreements, and TSAs. In addition, a seller may need to unwind its financing structure (such as ICO loans) and a buyer may need to set up a new financing structure including ensuring adequate cash in each new market/entity. This process is often very complex and time consuming.

The complexities include tax impacts of unwinding any existing intercompany financing structures, forecasting the level of working capital needed in each market, foreign currency risk, etc.

It is important that an entity considers the impact of interim operating models in this process, as these models have a direct effect on the timing of cash flows. These impacts may include:



- **Timing of cash flows in an agency or distributor market.** In these markets, where the buyer has purchased the business and often transferred all employees to the buyer, there will be no direct cash flows from the sale of product as the seller is transacting on the buyer's behalf. The buyer must consider the timing of cash receipts from the seller in its forecasting.
- **Net economic benefit (NEB) model countries.** The activities in the NEB markets are conducted by the seller, not buyer, and typically are settled in a limited number of countries (e.g., not in the market of the operating activity). The buyer needs to consider where the cash settlement will occur, what market costs associated with these local countries may be incurred, and the impact on any cash requirements.
- **Foreign currency impacts.** The settlement of NEB markets in a limited number of markets exposes the operating results to foreign exchange (FX) movements, as the NEB profit is typically calculated based on local currency profit. The buyer and seller should establish in the agreement how the FX rates will be determined, and each party may want to consider whether to hedge any such exposure.

Each party will also be affected upon the conclusion of the operating model agreements and should plan for the transition off the agreement, including any financing/structuring that needs to be established prior to the end of the agreements.

VAT (and financial flows)

The following represents a general summary of the VAT impacts, and this information should be verified per jurisdiction prior to implementing any of the models or transactions being performed or taking place as local country challenges, specifications, and particulars might be applicable.

a. **Disclosed agency**
For VAT purposes, the principal is the party supplying goods (or services) to the end customers and is liable for charging and accounting for any VAT due on such supplies (including reporting these transactions in its periodical VAT returns and other VAT compliance reports as required).

The principal should, in principle, issue VAT-compliant invoices to the end customers. However, under this model, the disclosed agent will typically issue invoices on behalf of the principal as part of the agency services it provides. Where this is the case, all credentials of the principal (e.g., name, address, VAT number, etc.) should be clearly disclosed or stated on the invoices issued by the disclosed agent to provide clarity as to who the supplier of these goods (or services) is toward end customers and/or tax authorities.

The disclosed agent should issue a separate VAT-compliant services invoice in its own name for the agency services it provides to the principal and is the party liable for collecting and accounting for any VAT on its services (and reporting such services in its periodical VAT returns and other VAT compliance reports as required).

b. **Undisclosed agency**
In an undisclosed agency structure, there is generally considered to be a "deemed buy-sell" transaction between principal/agent for VAT purposes (i.e., the principal is "deemed" to supply goods or services to the undisclosed agent, with the agent then being deemed to sell the goods or services it has "acquired" from the principal to the end customers in its own name, but on the principal's behalf). Note that, legally, title to the goods (or services) will be transferred directly from the principal to the end customers.

Each party in the chain should issue VAT-compliant invoices and other documentation in its own name and is liable for collecting and accounting for any VAT due on its supply of goods or services, including the "deemed" supplies, and reporting the supplies in its periodical VAT returns and other VAT compliance reports as required. From a VAT perspective, the agency fee should normally be subsumed in the deemed supply of the goods or services from the undisclosed agent to the end customers and should follow the same VAT treatment as the underlying supplies (i.e., the agency fee would be the differential between the undisclosed agent's deemed purchase price from the principal and its deemed sales price to the customer). Note that settling the agency fee via a separately issued invoice for agency services is usually not allowed from a VAT perspective in an undisclosed agency model.

c. **Distributor**
In a distributor model the seller will purchase goods or services from the buyer and sell to the customer in its own name (as opposed to the "deemed buy-sell" that occurs under the undisclosed agency model). Each party in the chain should issue VAT-compliant invoices and other documentation in its own name and is liable for collecting and accounting for any VAT due on its supply of goods or services (and reporting the supplies in its periodical VAT returns and other VAT compliance reports as required).

The seller, acting as a distributor, may issue a separate services invoice to the buyer for the distribution services provided, or the fee for such services could potentially be earned through the differential in purchase or sale price of the products. Where a separate services invoice is issued, the seller should issue a separate VAT-compliant services invoice in its own name for the distribution services it provides to the buyer and is the party liable for collecting and accounting for any VAT due on its services (and reporting such services in its periodical VAT returns and other VAT compliance reports as required).

d. **NEB**
The seller remains the party supplying the goods or services to the end customers. Hence, it would be liable for VAT due (if any) on such supplies and should issue VAT-compliant invoices to the end customers (including reporting these transactions in its periodical VAT returns and other VAT compliance reports as required).

Generally, for the seller to remit the "net economic benefit" of the supplies to the buyer, the buyer usually issues an invoice to the seller for services the buyer has performed (e.g., providing the seller with the right to operate the business in the respective markets). The buyer should issue a separate VAT-compliant services invoice in its own name for the services it provides to the seller and is the party liable for collecting and accounting for any VAT due on its services (and reporting such services in its periodical VAT returns and other VAT compliance reports as required).

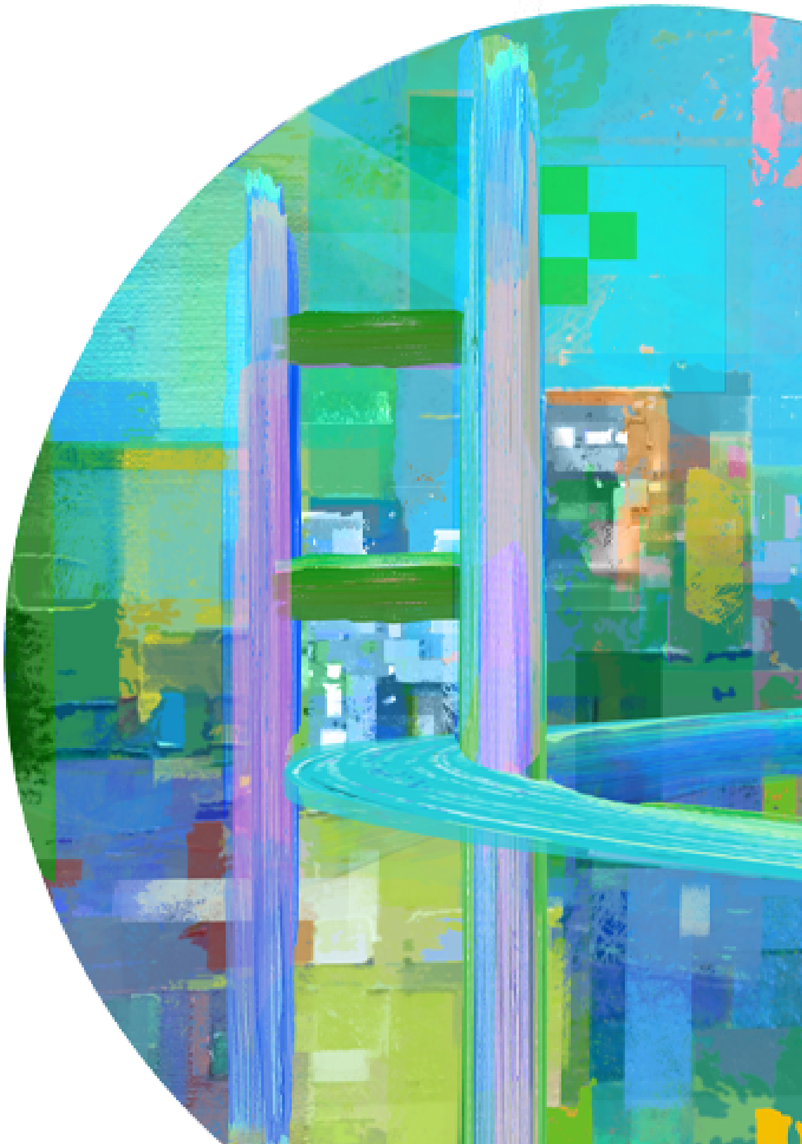
In all aforementioned scenarios where services and goods are being provided, the relevant place of supply rules should be taken into account to determine whether and where VAT should be accounted for, at which rate, and by which party.

In conclusion

There are four common interim operating model constructs that detail how legal entities transact with customers and other legal entities after principal close of an M&A transaction. Each of these IOM archetypes and their main characteristics as they relate to customers, people, and financials present unique cross-functional, regulatory, and strategic considerations for CFOs and other finance leaders.

Finance leaders who are able to develop strategies around the interim-state cash settlement, revenue recognition, governance, data segmentation, and VAT will be in the best position to deliver the goals of the transaction, maintain pace, and deliver market value, all the while enabling continuity of core operations.

These leaders and companies will be better equipped to transition to their end-state operating models if careful consideration is given to these business enablers.



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