Accounting for transaction costs incurred in initial public offerings

Background and issue

In an initial public offering on the Hong Kong stock exchange, it is a common practice for a company to seek an exchange listing for all or part of its shares as well as offering to issue new shares at the IPO price. A multitude of different types of expenses are incurred during the IPO process – the IPO costs – and the question arises as to how these IPO costs should be accounted for: should they be deducted from equity or should they be expensed in profit or loss?

The relevant guidance is found in HKAS 32.37 and 38.[1]

HKAS 32.37 states: *"The transaction costs of an equity transaction are accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided."*

HKAS 32.38 states: *"Transaction costs that relate jointly to more than one transaction (for example, costs of a concurrent offering of some shares and a stock exchange listing of other shares) are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions."*

In applying the guidance found in HKAS 32.37 and 38, it is clear that:

- Expenses that are directly attributable to the issue of new shares are accounted for as a deduction from equity.[2] An obvious example of such expenses is underwriting commission charged by underwriters for the new shares to be issued during the IPO.
- When shares are listed without any additional funding and issue of share capital (for example, in a listing by way of introduction whereby the company is seeking only to list its existing shares), the expenses incurred do not relate to the issue of equity instruments nor do they give rise to an asset. Therefore, such expenses are recognized in profit or loss as incurred.

However, in an IPO whereby a company is seeking an exchange listing for some or all of its shares as well as offering to issue new shares at the IPO price, careful professional judgment needs to be exercised regarding the application of HKAS 32.37 and 38 to the IPO costs incurred, which may be rather substantial in amounts. One key area requiring such exercise of professional judgment concerns the extent to which the IPO costs can be accounted for as a deduction from equity and centres on the following key questions:

- What is meant by an equity transaction? Does it refer to the offer of new shares only, or does it also include the listing of existing shares in the context of the IPO as a whole?
- What do the terms "incremental" and "directly attributable" mean?
- How should the requirements of HKAS 32.38 to allocate transaction costs that relate jointly to the listing of shares and the share offer be applied?

> **"A multitude of different types of expenses are incurred during the IPO process and the question arises as to how these IPO costs should be accounted for."**

Inappropriate application of judgment could result in a materially lower portion of the IPO costs being charged to profit or loss as listing expenses of existing shares, and a materially higher portion of the IPO costs being charged directly to equity than what it ought to be, or vice versa.

These issues have been previously raised to the International Financial Reporting Interpretations Committee (now the IFRS Interpretations Committee), which issued an agenda decision in September 2008 on IAS 32 *Transaction Costs to be Deducted from Equity*, noting that:

- Only incremental costs directly attributable to issuing new equity instruments or acquiring previously outstanding equity instruments are considered to be related to an equity transaction under IAS 32;
- Judgment will be required to determine which costs are related solely to other activities undertaken at the same time as issuing equity, such as becoming a public entity or acquiring an exchange listing, and which costs are related jointly to both activities and, therefore, are required to be allocated in accordance with IAS 32.38;
- Incremental costs are not limited to external costs; however, on assessing how much of the internal costs under scrutiny is "incremental," the company should identify the external cost that would have been incurred instead of the internal cost. Furthermore, the internal cost allocated to the equity transaction must be incurred in addition to on-going expenditures, in other words, it cannot simply be an allocation of, for example, payroll costs of permanent staff who would otherwise be employed on other projects; and
- Despite the fact that the terms "incremental" and "directly attributable" are not used with identical meanings throughout IFRSs, their notions are used in sufficiently similar ways throughout IFRSs which should allow constituents to apply them consistently.

In view of existing guidance, the IFRIC declined to provide further clarification on the extent to which transactions costs should be accounted for as a deduction from equity and how to allocate costs that relate jointly to

more than one transaction.

It is clear from the IFRIC agenda decision that the listing of shares and other related activities that do not involve the issue or acquisition of an entity's equity instruments are not "equity transactions" as contemplated in IAS 32.37, hence transaction costs relating to these activities should not be deducted from equity.

The second and third questions above, however, remain basically unanswered and continue to be the subject of much professional debate, judgment and interpretation. The IFRIC has emphasized in its agenda decision that companies should first identify the costs that relate specifically to the issue of new shares and those that relate specifically to the listing of shares, which should be recognized in equity and profit or loss respectively; and then allocate the remaining IPO costs which relate jointly to the issue of new shares and the listing of existing shares on a rational and consistent basis in accordance with IAS 32.38.

Accordingly, it would not be appropriate to treat all transaction costs of an IPO, excluding those that relate solely to the issue of new shares, as having been incurred jointly for the purpose of the issue of new shares and the listing of shares without further analysis.

With regard to incremental costs directly attributable to an equity transaction, the IFRIC agenda decision confirmed that such costs may include internal costs in addition to external costs. However, the allocation to equity should not include internal overhead costs merely because they can be directly allocated to the IPO transaction – to be considered "incremental" it is necessary to demonstrate that these internal costs were incurred because of the IPO project and would not otherwise have been incurred.

For example, payroll expenses for existing employees (even if working exclusively on the IPO project during certain lengthy periods of time), management time or administrative overheads would not normally be considered "incremental" costs. This is because these costs would have been incurred whether or not the IPO project had been undertaken.

On the other hand, travelling costs and other expenses incurred by these personnel while working on the IPO project may be incremental costs that are directly attributable to the IPO project. In practice, few internal costs will be regarded as "incremental costs that are directly attributable to an equity transaction" because the incremental part of the test will be difficult to demonstrate.

Further examples of costs, which do not meet the "incremental costs that are directly attributable" requirement, are costs of researching different types of equity instruments to be issued during the IPO transaction, or of ascertaining the suitability or feasibility of particular equity instruments. These costs, even though they may be incremental costs, are not directly attributable to the share offer. Such costs are recognized in profit or loss even if they relate to the newly issued shares.

Typical IPO costs and their accounting treatment

The following table provides examples of costs that are typically incurred in an IPO involving a concurrent listing of existing shares, and analyses whether the costs could

[1] *All references to HKFRS or HKAS apply equally to IFRS or IAS.*

[2] *For the purposes of this article "new shares" refers to those shares issued to raise new funds for the listing entity during the IPO. This would not include, for example, shares issued as part of a group reorganization prior to or at the time of the IPO, which is accounted for using the merger accounting method in accordance with Accounting Guideline 5* Merger Accounting for Common Control Combinations. *According to paragraph 12 of AG5, expenditure relating to a common control combination is expensed as incurred.*

Nature of costs	Equity / expense / joint
Stamp duties, share registration costs, cost of handling share applications and other regulatory fees relating to the issuance of new shares during the IPO	Equity
Commissions paid to employees acting as selling agents that relate to the share issue	Equity to the extent they are incremental
Underwriting fees	Equity
Listing fees	Expense (normally not material)
Tax and legal entity restructuring costs in anticipation of the IPO	Expense. Corporate restructurings are undertaken as a housekeeping matter to facilitate the listing process, and are not directly attributable to the issue of new shares.
Costs to draft new articles of incorporation, audit committee charter, by-laws and other agreements	Expense. Such corporate governance activities are undertaken as a housekeeping matter to facilitate the listing process and/or future operations of the company, and are not directly attributable to the issue of new shares.
Reporting Accountants' fees relating to prospectus	Joint. A prospectus serves as both an offer document under the relevant Companies Ordinance, as well as a listing document under the listing rules of the HKEx and the Securities and Futures (Stock Market Listing) Rules. However, in situations where additional fees and costs are incurred by the company due to delays in and postponement of the IPO, the costs relating to the earlier attempt that can no longer be leveraged on should be expensed in profit or loss.
Valuation fees in respect of valuation of shares	Equity to the extent they are incremental
Valuation fees in respect of valuation of assets other than shares (e.g. property) if the valuation is required to be disclosed in the prospectus	Joint. A prospectus (or similar) may be required for an offer of shares without a listing and vice versa, but in practice IPO documents typically relate to both the share offer and the listing. However, if the valuation is not required to be disclosed in the prospectus, such expense is not directly attributable to the IPO and should be expensed.
Legal and tax advice fees (other than those relating to restructuring in IPO above)	Joint. Legal and tax advice is typically required for both the share offer and the listing to comply with the requirements established by the Securities and Futures Commission, the HKEx and other regulators. Similar to the case for reporting accountants' fees, in situations where additional fees and costs are incurred by the company due to delays in and postponement of the IPO, the additional fees and costs caused by the delays and postponement should be expensed in profit or loss.

be regarded as:

- "Incremental costs directly attributable" to the issuance of new shares during the IPO and thus be deducted from equity in terms of HKAS 32.37 (classified as "Equity" in the above table);
- Relating solely to listing or other activities undertaken at the same time as the share issue which should be expensed (classified as "Expense" in the above table); or
- Costs that relate jointly to both the issuance of new shares and the listing of existing shares which should be allocated in accordance with HKAS 32.38 (classified as "Joint" in the above table).

Note: Costs identified as "Joint" in the table above would only be allocated if an IPO involves a concurrent listing of existing shares. No allocation would be required if an IPO does not involve listing of existing shares: instead the costs classified as "Joint" above would be treated as costs which relate entirely to the new issuance and should be deducted from equity. For instance, in a Hong Kong IPO whereby the company issues a new class of shares and only that new class will be listed on the HKEx, all the costs which are of the nature of those costs classified as "Joint" above will be charged directly to equity as deduction of gross proceeds from issuance of the new shares. A common example of this instance in a Hong Kong IPO is a H share IPO of a joint stock company established in the Mainland whereby the existing domestic shares of the IPO company, including its existing A shares, are not traded on HKEx. Likewise, in an introduction of a listing applicant, which only involves the listing of existing shares and does not involve an offer for subscription of new

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Nature of costs	Equity / expense / joint
Prospectus preparation, design and printing costs	Joint. A prospectus serves as both an offer document under the relevant Companies Ordinance, as well as a listing document under the listing rules of the HKEx and the Securities and Futures (Stock Market Listing) Rules.
Sponsor's fees	Joint. The appointment of a sponsor is an initial listing requirement regardless of whether the listing involves any issue of new shares. However, the activities of the sponsor related to compliance with the continuing listing obligations/requirements of the HKEx should be expensed.
Public relations consultants' fees	Expense. Companies typically engage PR consultants to promote the image and branding of the company. Although these promotional activities may raise the company's profile and hence contribute to the ability to issue new shares, such PR costs and other marketing costs should be regarded as primarily related to the marketing of the company itself. Accordingly, in most situations marketing costs for an IPO are not directly attributable to the share issue and therefore should be expensed.
Road show costs, press conferences and advertising or promotional activity costs	The costs of all forms of advertising or promotional activity fall into the "Expense" category. Although the activity may assist in the sale of new shares to potential investors and hence contributes to raising equity, the associated costs are generally not sufficiently directly related to the share issues to justify deduction from equity even as an allocated joint cost. Instead, the costs would be expensed. However, determining whether an item is an advertising or promotional activity would require judgment as it depends on facts and circumstances. Also, any costs of the activity which are not incremental e.g. allocation of management time, should be expensed regardless of the nature of the activity.

shares of the listing applicant, all of those costs classified as Joint above would be treated as expense in profit or loss.

The classifications are made on the premise that the costs discussed arose in a typical IPO in Hong Kong involving a concurrent listing of existing shares. As always, this assessment should be a case-by-case analysis taking into account the specific contractual provisions and other facts and circumstances surrounding each case.

The table above gives a general indication of how IPO costs could be regarded for accounting purposes, and it is emphasized that management should exercise professional judgment in classifying the IPO costs to the Expense, Equity, or Joint categories as used in the table above according to their nature. The onus is on the companies to keep track of the costs incurred and to classify them into these three categories according to their nature.

Costs that relate jointly to the listing and share offer (i.e. those classified as "Joint" in the table above) should be allocated between these activities on a rational and consistent basis, as required by HKAS 32.38. An appropriate basis of allocation should be selected using careful judgment and after consideration of all relevant facts and circumstances. Factors for consideration in determining whether the selected basis of allocation is "rational" include, but are not limited to, the following:

- An allocation between listing of existing shares and issue of new shares should not result in the costs attributed to either of the two components being greater than the costs that would be incurred if either were a standalone transaction; and
- Whether the extent of the work involved would have been different if only one part of the transaction were undertaken.

"The onus is on the companies to keep track of the costs incurred and to classify them into these three categories according to their nature."

A key factor for consideration in determining whether the selected basis of allocation meets the "consistent" requirement of HKAS 32.38 is the accounting policy already adopted by the reporting entity for similar costs. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraph 13 requires that "an entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an HKFRS specifically requires or permits categorization of items for which different policies may be appropriate. If an HKFRS requires or permits such categorization, an appropriate accounting policy shall be selected and applied consistently to each category."

To illustrate, let us assume that H Limited is a company that is already listed in the HKEx. In 2014, it undertook an IPO project whereby new shares of one of its subsidiaries (S1 Limited) were issued and all existing shares of S1 Limited were listed at the same time. Assume that H Limited retains control over S1 Limited after the IPO of S1 Limited.

In the above example, certain IPO costs were incurred by the Group during the IPO of S1 Limited, which are of the nature falling under the Joint category described in the above tables. H Limited would not be meeting the "consistent" requirement of HKAS 32.38 in its consolidated financial statements of H Limited for the year ending 31 December 2014, if these joint IPO costs are allocated to the listing and share issuance of S1 Limited's shares using a different basis of allocation from that used to allocate the joint IPO costs incurred during the IPO of H Limited itself, assuming the prevailing accounting standard then was also HKAS 32.

In the absence of a more appropriate rational basis for apportionment, a commonly adopted practice of allocating the jointly incurred costs is based on the proportion of number of new shares issued relative to the total number of shares in issue and listed on the HKEx after listing (i.e. new and existing shares, which have become listed through the IPO).

To conclude, the accounting for transaction costs associated with an IPO is an area that is complex and requires judgment. Some diversity of practices in past transactions have been noted, hence this article is intended to clarify the application of certain aspects of the standards under HKFRS with the objective of helping to reduce the diversity in forthcoming transactions.

Illustration

This example provides an illustration of how IPO costs may be analyzed and recognized in equity and profit or loss respectively, depending on their nature. This is a simplified example and in practice analysis of the costs involves careful judgment and a consideration of all relevant facts and circumstances. Also, for simplicity sake, tax effects have been ignored.

Assume that B Limited undertakes an IPO in which 250 million new shares are issued and a total of 750 million new and existing shares are listed. Costs incurred for the IPO include:

- Underwriting fees of HK$5,000,000;
- Listing fee of HK$650,000;
- Public relations consultants' fees of HK$250,000; and
- Other costs totalling HK$4,350,000, which relate jointly to the share issue and listing.

In this case, the underwriting fees should be deducted from equity, the listing fee and PR consultants' fees should be expensed, and other costs which relate jointly to the share issue and listing should be allocated between these components on a rational and consistent basis, for example based on the proportion of number of new shares issued relative to the total number of shares in issue and listed on the HKEx after listing as follows:

Allocation to the new shares issued	(250m / 750m) x HK$4,350,000 = HK$1,450,000
Allocation to the listing	(500m / 750m) x HK$4,350,000 = HK$2,900,000

The journal entry would be as follows:

	Debit (HK$'000)	Credit (HK$'000)
Equity (5,000 underwriting fees + 1,450 joint expense allocation)	6,450	
Expense (profit or loss) (650 listing fee + 250 PR consultants' fees + 2,900 joint expense allocation)	3,800	
Bank		10,250

Further notes:

1. *If, for example, the IPO took place in early part of 2014 and the entity is preparing its consolidated financial statements for the year ended 31 December 2013, then the question of how to treat the costs incurred to date arises, if those costs are of a nature which qualifies for charging against equity. IAS 32 does not specifically deal with this question. In practice, two methods are accepted: the entity would treat the costs incurred up to 31 December 2013 that are of a nature which qualifies for charging against equity when the new shares are issued subsequently in early 2014 as either a prepayment or as equity in its consolidated statement of financial position as at 31 December 2013 (such method to be applied consistently). However, those costs incurred up to 31 December 2013 that would not be qualified to be charged against equity when the new shares are issued should be immediately expensed in 2013 financial statements, rather than carried forward as prepayments for expensing in 2014.*

2. *Those costs qualified to charge against equity (i.e. HK$6,450,000 in the example above) would be classified as financing outflow in the consolidated statement of cash flows; the remaining HK$3,800,000 of IPO costs that are recognized as expense in profit or loss should be included in cash flows from operating activities.*

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