THE STANDARD STANCE

Analysing Transaction Costs During Initial Public Offerings

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BDO

Initial Public Offerings (IPOs) are noteworthy events for companies, marking the transition from private to public ownership. An essential aspect of the IPO process is accounting for the associated transaction costs - a multitude of distinct types of expenses are incurred during the IPO process, therefore a critical question arises as to how these expenses should be accounted for.

This publication primarily covers the accounting treatment for costs of an IPO that involves the issuance of new shares and a stock market listing.

COMMON FAQs CONCERNING ACCOUNTING FOR THE TRANSACTION COSTS

How are transaction costs associated with the IPO process accounted for?

There is often a debate around accounting for expenses incurred by companies during the IPO process: whether these expenses should be deducted against the equity, or be recorded as an expense in the statement of profit and loss.

The relevant accounting standard that guides the accounting for transaction costs is found in Ind AS 32 'Financial Instruments: Presentation'. Paragraph 37 of this standard requires that *"the transaction costs of an equity transaction are accounted for as a deduction from equity to the extent they are incremental cost directly attributable to the equity transaction that otherwise would have been avoided"*.

During the IPO process, an entity typically incurs various costs in issuing its equity instruments, such as registration and other regulatory fees; payments made to legal, accounting and other professional advisers; printing costs; and stamp duties. It is clear from the above requirements of Ind AS 32 that such costs are accounted for as a deduction from equity, but only to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided.

Examples of transaction costs that generally may be considered incremental costs that are directly attributable to the equity transaction could include:

- registration and other regulatory fees
- underwriting costs and brokerage fees
- amounts paid to lawyers
- fees paid to investment bankers and other professional advisers
- fees paid to brokers and dealers
- fees and commissions paid to other agents
- stamp duties

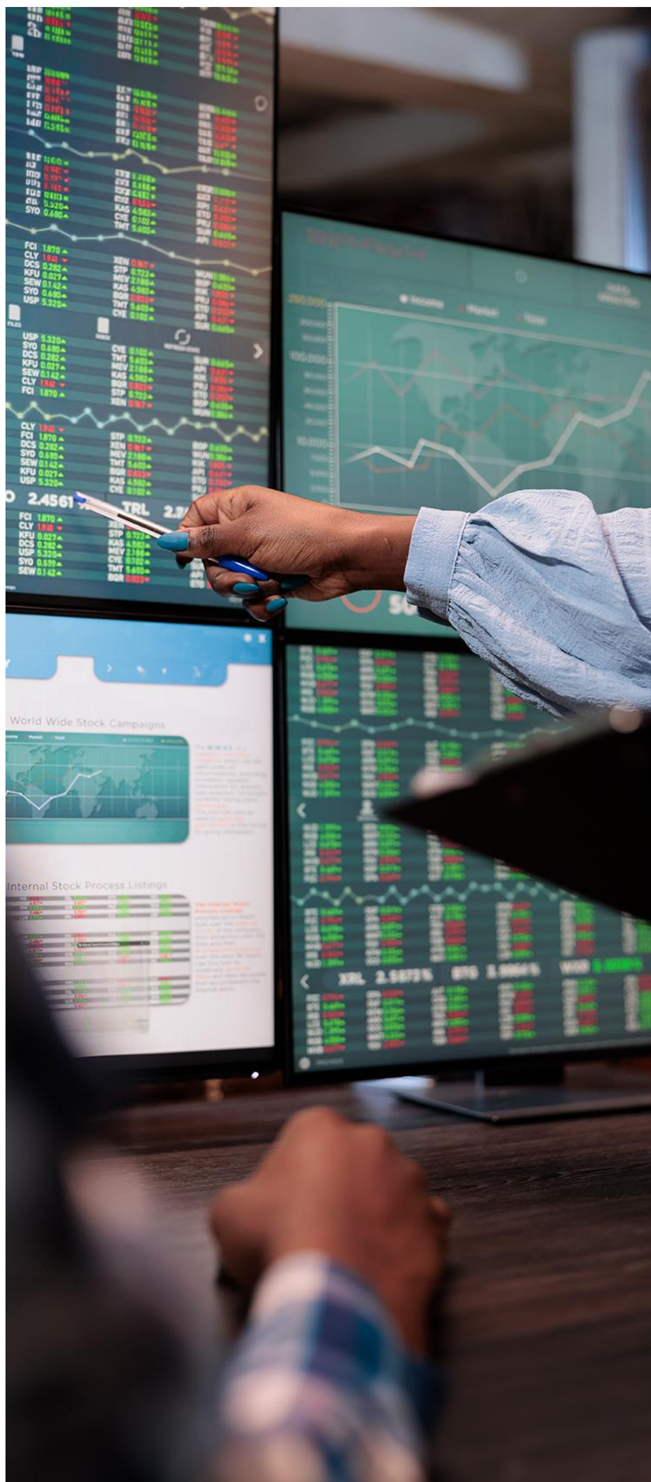
It may be noted that even with respect to the above expenses, further analysis may sometimes be required to assess whether they are truly in the nature of incremental costs directly attributable to the equity transaction. For example, professional fees paid to a consultant to perform an initial IPO diagnostic study are not an incremental cost directly attributable to an equity transaction, as the management may decide not to go ahead with the IPO based on this diagnostic study.

Internal administrative or holding costs, for example, costs which would have been incurred in any case, if the equity instrument had not been issued, are not considered to be incremental or directly attributable. For instance, payroll expenses (even if working exclusively on the IPO project) would have been incurred, if the equity instruments had not been issued.

Furthermore, costs for marketing an IPO, including the 'roadshow,' generally do not meet the definition of a transaction cost. Such costs primarily relate to the marketing of the entity itself. Therefore, in most situations, marketing costs for an IPO do not meet the definition of directly attributable and should be expensed through the profit and loss account.

Should costs attributable to the listing of existing shares be expensed as they are incurred or be accounted for as a deduction from equity?

Ind AS 32 requires that only costs of 'issuing or acquiring' equity are recognised in equity. Accordingly, it seems clear that costs incurred in listing the existing shares on a stock exchange are not transaction costs relating to the issue of an equity instrument. These costs are simply incurred to make the existing shares more marketable and are not related to the equity instrument's issue. In some situations, the existing shares might be included in a 'secondary offering' (that is, a sale of shares by existing shareholders as opposed to the company itself). As the cash generated from the sale of secondary shares is given to the selling shareholders, rather than the company, the associated costs are not equity transaction costs. Therefore, these costs should be charged to profit or loss, unless they are specifically charged back to the selling shareholders.



How are transaction costs that relate jointly to the listing of existing equity shares and issuance of new equity shares accounted for?

In some cases, where an entity issues new equity shares and simultaneously lists them, there could be judgement involved in assessing whether a portion or entire amount of such expenses should be recognised in equity.

An IPO may involve both listing existing equity shares and issuing new shares. According to Ind AS 32.38, the transaction costs that relate jointly to more than one transaction, i.e., in the given case, the costs of a concurrent issuance of new shares and a stock exchange listing of the existing shares, are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.

As specified earlier, the costs incurred from listing existing shares are not transaction costs since it does not result in an increase in capital, and therefore should be expensed as incurred to the income statement. Thus, in case of a concurrent offering of new shares and a stock exchange listing of the existing shares, firstly, the companies should identify the costs specifically attributable to the issuance of new shares. Such costs shall be accounted for as a deduction from equity (for example, there may be costs like stamp duty and registration costs, incurred in issuing new shares, which are directly attributable to the issuance of the new shares with no need for any allocation). Likewise, those costs directly attributable to the listing of the newly listed but previously existing shares should be charged to the income statement.

All other costs of the IPO that relate jointly to both components of the transaction should be allocated using a rational basis. An appropriate basis of allocation should be selected using careful judgement and after consideration of all relevant facts and circumstances. Factors for consideration include, but are not limited to, the following:

- an allocation between the listing and issue of 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 stand-alone transaction;
- whether the extent of work involved would have been different if only one part of the transaction were undertaken; and
- if the work covers both components equally, then a 50:50 allocation may be reasonable.

The allocation of joint costs based on the proportion of new shares issued relative to the total number of shares listed on the stock exchange is an acceptable approach. Another basis may also be appropriate if the same can be justified in the given situation.

Example:

Company G issues 160 new shares and lists 80 existing shares in an IPO. The total costs related to both existing and new shares are 300. G allocates the costs between the listing of the existing shares and the issue of new shares based on the number of shares as follows:

- Issuing new shares: 200 (300 x 160 / 240). This amount is recognised directly in equity.
- Listing existing shares: 100 (300 x 80 / 240). This amount is recognised in profit or loss.

How are certain typical costs generally incurred during an IPO accounted for as per the requirements of Ind AS 32?

The following table provides examples of the typical IPO costs and their accounting treatment.

Nature of costs	Allocation (Share issue, listing, or both?)
Listing fees paid to the stock exchange	The listing fee is paid to the stock exchange and does not relate to the issuance of the equity instrument. Therefore, the fees paid should be charged to the income statement as incurred.
Stamp duty for shares	The stamp duty paid by the companies on issuance of new shares should be deducted from the equity.
Legal fees	The companies incur legal fees both for the offer of shares to the public and the listing procedures. Therefore, such expenses should be allocated between the share issue and the listing on a rational and consistent basis. However, there could be some fees that may relate specifically to the share issue or the listing; in that case, such costs would be recognised in equity or charged to the income statement, as appropriate.
Valuation fees	The fees in respect of the valuation of the equity shares may be considered as a share issue expense to the extent they are incremental.
Underwriting fees	These typically relate to the shares issue expense and therefore such costs should be deducted from the equity.
Design and printing costs of the prospectus	The prospectus serves as both an offer document and the listing document under the listing rules. Therefore, such costs should be allocated between share issue expense (charged to equity) and listing expense (charged to income statement).
Public relations consultant fees	The company typically engages consultants to promote its image and branding. In most cases, such costs are not directly attributable to the share issue and therefore should be expensed of in profit and loss.
Fees paid to the merchant bankers	These costs should be allocated to both the share issue expense and the listing fee on a rational basis.

How are transaction costs associated with the increase in authorised share capital accounted for?

Sometimes, companies increase their authorised share capital intending to issue equity shares in the future. The company would incur costs, such as stamp duty, registration fees, lawyer's fees, etc. for the same. There is no specific guidance in accounting standards on how to treat costs incurred before the equity transaction has been recorded.

The companies incur such costs in anticipation of an issuance of equity instruments. Therefore, one could argue that the costs incurred for increasing the authorised share capital should be recognised as a prepayment (asset) in the balance sheet until the equity instrument is recognised. The deferred cost (recognised as a prepayment) is then reclassified as a deduction from the equity when the related equity instruments are recognised. The deferred cost should be recognised as an expense in profit or loss if the issuance of the equity shares is no longer expected to be completed.

A similar accounting treatment should be followed where at the reporting date, the IPO may be in progress. To the extent the expenses are identified as share issue expenses, the same may be recorded as a prepayment, if the IPO is probable. Once the IPO occurs and equity shares are issued, the prepayment should be debited to equity.

How are transaction costs related to creating the non-controlling interest (NCI) accounted for?

The creation of NCI in a subsidiary in the consolidated financial statements is in effect the issuance of new equity interests in the consolidated group. This is the case even if the NCI is created by selling the existing shares of a subsidiary to a third party; for example, a parent selling a portion of its shares in a subsidiary to third parties while retaining control. This is because, from the group's perspective, the shares of the subsidiary held by the parent are eliminated in the consolidated financial statements, and the creation of NCI leads to an increase in equity in the consolidated financial statements. Accordingly, the transaction costs attributable to the creation of NCI should be recognised directly in equity in the consolidated financial statements, because they are costs of an equity transaction in the consolidated financial statements.

However, if the equity shares of a subsidiary are listed in connection with the creation of NCI, then we believe that an entity should determine which costs are directly attributable to the equity issuance, i.e. creation of the NCI, and should be deducted from equity in the consolidated financial statements, and which costs relate to the listing and should be expensed when they are incurred.

Example:

Company A owns 100% of the shares in Company B. Company A is planning to list all existing shares of Company B and simultaneously sell 20% of its shares in Company B to third parties. Company B will not legally issue any new shares as part of the listing and selling process and Company A will not lose control of Company B. As a result of the transaction, Company A will recognise NCI in its consolidated financial statements.

Company A and Company B incur costs of INR 100,000 and INR 20,000 respectively that are directly attributable to the sale of 20% of the shares in Company B to third parties. Company B also incurs costs of INR 50,000 related to the listing. In its standalone financial statements, Company B should recognise the total costs incurred of INR 70,000 in profit or loss because there is no equity transaction from B's perspective. In Company A's consolidated financial statements, the costs of INR 120,000 that are directly attributable to the sale of 20% of the shares in B should be recognised directly in equity. However, the costs of INR 50,000 that relate to the listing should be recognised in profit or loss.

CONCLUSION

The accounting for transaction costs associated with an IPO is a complex area and judgement will be required to determine the appropriate accounting, particularly when an IPO involves both listing existing shares and issuing new ones.

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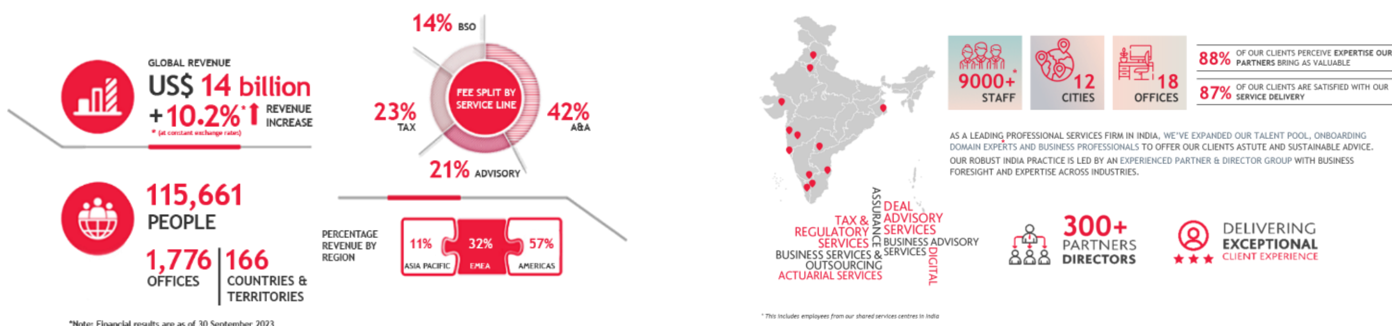

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